

# **Securitization of Student Loans: A Proposal to Reform Federal Accounting, Reduce Government Risk, and Introduce Market Mechanisms as Indicators of Quality Education**

Robert Proudfoot

9 U. MASS. L. REV. 6

## **ABSTRACT**

This Article outlines looming budgetary and accounting issues with federal student loans and proposes securitization as an innovative mechanism to reform federal accounting, reduce federal balance sheet risk, and provide a new education quality indicator. The current federal loan program is unsustainable because it overestimates the repayment rates and underestimates the cost of certain loan programs. Securitization will reduce that federal risk. Additionally, by forcing academic institutions to bear some of the risk, securitization will create a neutral pricing mechanism outside the direct control of federal regulators to show whether academic institutions provide a quality education. While complicated, this proposal provides an innovative, back-end-loaded-solution to introduce risk-based pricing into student loan programs without placing the risks fully on uninformed students.

## **AUTHOR NOTE**

Robert Proudfoot is a 2013 graduate of University of Kentucky College of Law. Before attending law school, he spent a year at the Department of Education Office of Inspector General as a compliance inspector. He would like to thank University of Kentucky's Dean Douglas Michael for allowing him to write this paper as an independent study, Professor Scott Bauries and Professor Christopher Frost for their guidance, and the Law Library's excellent research staff (Tina Brooks, Ryan Valentin, and Beau Steenken). He also would like to thank his wife, Christy Te, for listening to him talk about student loan policy so abstractly when it impacted their lives so directly.

I.	INTRODUCTION .....	8
II.	HISTORY OF HIGHER EDUCATION FINANCING .....	11
A.	Post World War II Period .....	12
B.	Congress Expands Student Loan Funding .....	14
C.	Policy Issues Concerning Government Backed Loans .....	19
D.	Current Programs .....	24
III.	GOVERNMENT RISKS .....	27
A.	Federal Accounting and Budget Risks.....	29
B.	Risks Stemming From a Lack of Quality Education Control .....	37
IV.	HISTORY OF STUDENT LOAN SECURITIZATION.....	44
A.	Securitization Principles .....	46
B.	Government Sponsored Enterprises & Securitization .....	47
C.	Dodd-Frank “Skin in the Game” Risk Retention Provisions.....	49
D.	Securitization of Student Loans .....	51
E.	Current Market for Securitized Student Loans .....	52
V.	PROPOSALS TO REDUCE GOVERNMENT RISK.....	53
A.	Proposals that Can Be Implemented Immediately .....	54
B.	Proposals that Require Further Study .....	60
VI.	CONCLUSION .....	66

## I. INTRODUCTION

What is the purpose of a postsecondary education? Everyone has a different answer. Academics claim that postsecondary education enhances a student's understanding of his or her world. Politicians believe that postsecondary education creates a better and more informed society and electorate. Employers use education as a barrier to entry to sort through potential employees and to verify an applicant's skill sets. Students may not even know why they are in school, only that it is supposed to be the next step on the ladder to a successful life. But, at the end of the day, higher education is an investment of resources—time, money, and opportunity cost.<sup>1</sup>

The question then becomes: who can best determine if an educational investment is worth the time, the expense, and the effort? Naturally, the student making the educational choice comes to mind as the best bearer of risk because he or she knows his or her own capabilities, desires, and limitations.<sup>2</sup> The optimal allocation of risk for an investment in higher education, however, is complicated because this type of investment presents a classic example of informational asymmetry.<sup>3</sup>

Informational asymmetry is an economic term that describes an inefficient market caused by one party in a transaction having more information than the other, which makes it impossible to have rational, optimal pricing for a product.<sup>4</sup> Students, for example, only make an educational investment once or possibly twice in their lifetime. Academic institutions, on the other hand, make decisions thousands of times per semester on whom to enroll, what to teach, and how to educate students effectively. State and federal regulators also have had decades of experience reviewing institutional quality and abuses. This

---

<sup>1</sup> See Michael Simkovic, *Risk-Based Student Loans*, 70 WASH & LEE L. REV. 527, 531–32 (2013).

<sup>2</sup> See *id.* at 590 (asserting that students would benefit from a risk-based system of student loan pricing as it would force students to internalize the economic risks when making decisions regarding their education).

<sup>3</sup> See Michael C. Macchiarola & Arun Abraham, *Options for Student Borrowers: A Derivatives-Based Proposal to Protect Students and Control Debt-Fueled Inflation in the Higher Education Market*, 20 CORNELL J.L. & PUB. POL'Y 67, 110–11 (2010).

<sup>4</sup> *Id.* (explaining the economic theory of informational asymmetry by describing the inherent differences between the law students as the consumers of a legal education and the law schools and lenders as the sellers of a legal education).

imbalance of information creates an inefficient market where the average student makes an uninformed decision about his or her educational investment. While there have been recent efforts to promote disclosure to level the information-divide between participants, students will probably never have the same information as institutions.

This informational asymmetry creates a bizarre relationship where an uninformed student makes an education choice that is supported by federal student loans. As a result the federal government—not the academic institution—bears the risk of whether the student will have a favorable outcome from his or her education investment.<sup>5</sup> Even though the federal government has approximately \$1 trillion in student loan debt, its capacity to regulate the quality of academic institutions is limited. Our current student loan system exposes the federal government to large risks but fails to provide quality education indicators to prospective or current students. Any proposal to reform federal student loan programs should incentivize the fair valuing of loans on the federal balance sheet, reduce government risk, and provide a quality education indicator to institutions to adjust their policies to reduce the risk of bad outcomes from students with asymmetrical information. Additionally, student loans—not tuition costs—are the proper focus of reform because the federal government bears the risk when a student pays his or her tuition with loans.

Securitization is underutilized in federal student loan programs and could be used to reduce risk and to create a market price for assets. Securitization is a financial term that refers to the pooling of debt instruments for sale to third-party investors to offset risks associated with owning or lending against an asset.<sup>6</sup> Securitizing student loans

---

<sup>5</sup> This allocation of risk analytically is similar to the inefficient mortgage market that led to the sub-prime crisis of 2008: homeowners bought houses assuming successful outcomes, the federal government indirectly was burdened with homeowners' mortgage risks through Government Sponsored Enterprises—Fannie Mae, Freddie Mac—and the banks that were responsible for originating the loans carried little risk. See April A. Wimberg, *Comparing the Education Bubble to the Housing Bubble: Will Universities be Too Big to Fail?*, 51 U. LOUISVILLE L. REV. 177, 190–91 (2012).

<sup>6</sup> See Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1373–75 (1991); see also Jonathan C. Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. 1229, 1239–44 (2012); Steven L. Schwarcz, *What is Securitization? And for What Purpose?*, 85 S. CAL. L. REV. 1283, 1297 (2012).

can force accurate accounting for third-party sales, reduce federal debt, and provide an additional feedback mechanism for academic institutions and for accreditors to improve education outcomes for uninformed students. Securitization is only possible if the loans are valued accurately by the Department of Education (Department) through fair accounting principles to minimize the losses when the loans are sold. Once the loans are valued accurately, securitization provides a method to deleverage government risk through sales to private investors—there is already current, viable market demand. Finally, if academic institutions are required to share the losses, or gains, from securitization—much like originators of asset-backed securities have risk retention requirements in Dodd-Frank—then institutions will receive feedback from a third-party market-pricing mechanism as to whether their educational product is a quality investment. There have been other efforts to reform student loans in the past, such as bankruptcy reform,<sup>7</sup> but none have focused on reform through the federal budget—which historically has been the primary catalyst for policy changes.

This Article analyzes the risks created by federal student loan programs and proposes changes for reducing or eliminating these risks. Part II provides a brief history of higher education financing, including an overview of federal student loan policies as they relate to the federal budget. Using this budgetary perspective, Part III identifies two types of government risks that have not been addressed in other student loan reform proposals: federal accounting and budget risks, and the risks stemming from the lack of quality education control. Part IV considers student loan repayment rates as a simplified quality education indicator and provides a brief history of student loan securitization. Finally, Part V proposes changes for reducing or eliminating the risks created by the current federal student loan programs. Specifically, this Article proposes reforming existing legislation to more accurately show the riskiness of student loan debt, securitizing federal student loan assets to reduce government risk, and creating market-based risk sharing to offset some or all losses from

---

<sup>7</sup> See 11 U.S.C. § 523(a)(8) (2012) (prohibits discharges of student loans in bankruptcy); Note, *Ending Student Loan Exceptionalism: The Case for Risk-Based Pricing and Dischargeability*, 126 HARV. L. REV. 587, 603 (2012) [hereinafter *Harvard Note*] (arguing that repealing § 523(a)(8) would decrease indebtedness and defaults by permitting the most financially distressed borrowers to discharge their student loan debt in bankruptcy).

securitization and to close the feedback loop between students, accreditors, institutions, and regulators.

## II. HISTORY OF HIGHER EDUCATION FINANCING

Prior to the advent of “federal aid,” extending credit to an unproven student was a risky proposition. Student loans were investments in a person’s future-earnings capability or, at the very least, in his or her ability to repay the loan with no collateral to reduce the risk of default.<sup>8</sup> Universities rarely extended credit to students. Milton Friedman, in his 1955 essay *The Role of Government in Education*, aptly explained this risk and the corresponding underinvestment in education:

This underinvestment in human capital presumably reflects an imperfection in the capital market: investment in human beings cannot be financed on the same terms or with the same ease as investment in physical capital. It is easy to see why there would be such a difference. If a fixed money loan is made to finance investment in physical capital, the lender can get some security for his loan in the form of a mortgage or residual claim to the physical asset itself, and he can count on realizing at least part of his investment in case of necessity by selling the physical asset. If he makes a comparable loan to increase the earning power of a human being, he clearly cannot get any comparable security; in a non-slave state, the individual embodying the investment cannot be bought and sold.<sup>9</sup>

This investment uncertainty makes private entities reluctant to provide student loans. There are grim, actuarial calculations to consider: the person could fail to complete his or her studies, become severely disabled, or die.<sup>10</sup>

Further, a quality education does not translate necessarily into a successful outcome relative to earnings or employment. A student may also choose a course of study that makes it difficult to obtain employment—studying law, the arts, or architecture. Also, even if a student has an education, he or she may not have the skill sets necessary to secure employment in an ever-changing business environment.

---

<sup>8</sup> MILTON FRIEDMAN, *The Role of Government in Education, in CAPITALISM AND FREEDOM* 85, 102 (Univ. of Chicago Press 40th ed. 2009) (1962).

<sup>9</sup> *Id.* at 102.

<sup>10</sup> *Id.*

For over eight centuries, academic institutions have struggled to find ways to lend money to students, either through credit enhancements or government assistance. In 1240, Oxford University developed the concept of a loan chest, which became widely used in Europe to assist financially-needy students.<sup>11</sup> A student who did not have enough money to pay for school would deposit an item of personal property in the loan chest as security in exchange for tuition for the semester.<sup>12</sup> If the student did not pay, then the academic institution would sell the student's collateral to recover its loss.<sup>13</sup>

In the United States, instead of requiring credit enhancements similar to the collateral required for loan chests, the federal government more recently has decided to bear the risk of student loans.<sup>14</sup> By bearing the risk of student loans, the government expands access to higher education and, in theory, receives a greater number of highly trained, work-ready citizens in return.<sup>15</sup>

All major shifts in student loan policies have been driven primarily by their favorable impact to the federal budget. This is true for each of the following: the switch from direct to guaranteed loans in 1965, the use of Sallie Mae as a securitizer in 1972, changes to the accounting of federally-owned loans in 1990, and the switch from guaranteed loans back to direct loans in 2010. By understanding this historical context, it becomes possible to evaluate the success of future student loan reform proposals. Any new reform to student loans must directly address and resolve budgetary issues to be effective.

### A. Post World War II Period

The G.I. Bill after World War II formed the conceptual basis of federal aid for postsecondary education. Titled the Servicemen's Readjustment Act of 1944, the program paid tuition expenses and

---

<sup>11</sup> See *Middle Ages*, UNIVERSITY OF OXFORD: FINANCE DIVISION, <http://www.admin.ox.ac.uk/finance/information/history/middleages/> (last visited Feb. 9, 2013) (discussing the establishment of loans chests in 1240).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> See, e.g., Simkovic, *supra* note 1, at 550 (“[T]he U.S. [has] shifted toward a centralized, taxpayer-funded, and government-coordinated model of university-based scientific and technical research, coupled with increased education subsidies.”).

<sup>15</sup> *Id.* at 532–47 (citing statistical data supporting the theory that education leads to better employment outcomes).

living allowances to qualifying veterans when they returned home after the war.<sup>16</sup> The cost of this program was a direct expense to the federal budget as a grant program. The Department of Veteran Affairs (VA) approved the eligibility of academic institutions for the program based on the recommendations of state agencies.<sup>17</sup> As would become a recurring theme in federal funding of higher education, the VA and other federal entities did not evaluate institutions based on the quality of education; instead, federal entities relied on the opinions of state regulators and accreditors.

This delegation of regulatory authority has been referred to informally as the “triad” of actors—federal agencies, state agencies, and accreditors—in educational quality assurance.<sup>18</sup> This delegation was formalized in 20 U.S.C. § 1011c, creating the National Advisory Committee on Institutional Quality and Integrity (NACIQI) to determine standards for accreditation, state licensing, and institutional eligibility.<sup>19</sup> In addition to determining accreditation standards by a committee, Congress passed 20 U.S.C. § 1232a in 1970 to limit the federal government’s power in regulating education.<sup>20</sup> In part, § 1232a states, “No provision of any applicable program shall be construed to authorize any department, agency, officer, or employee of the United States to exercise any direction, supervision, or control over the

---

<sup>16</sup> Servicemen’s Readjustment Act of 1944, Pub. L. No. 78-346, 58 Stat. 284, 287–89 (codified as amended in scattered sections of 38 U.S.C.); *History of the GI Bill*, NAVY PERSONNEL COMMAND, <http://www.public.navy.mil/BUPERS-NPC/CAREER/EDUCATION/GIBILL/Pages/GIBillHistory.aspx> (last visited Dec. 12, 2013) (discussing the fact that although earlier veteran assistance programs existed, there was not a large education assistance component until World War II).

<sup>17</sup> See Servicemen’s Readjustment Act of 1944 § 400, 58 Stat. at 289.

<sup>18</sup> *Report to the U.S. Secretary of Education—Accreditation Policy Recommendations*, NAT’L ADVISORY COMM. ON INST. QUALITY AND INTEGRITY—U.S. DEP’T EDUC. (Apr. 1, 2012), <http://www2.ed.gov/about/bdscomm/list/naciqi-dir/2012-spring/teleconference-2012/naciqi-final-report.pdf> [hereinafter *Higher Education Accreditation*].

<sup>19</sup> 20 U.S.C. § 1011c(a), (c) (2012); H.R. REP. NO. 112-177, at 19 (2011) (discussing the “triad” regulatory structure in higher education and Congressional delegation of the regulation of the quality of education to accreditors).

<sup>20</sup> See Robert S. Eitel & Kent D. Talbert, *The Road to a National Curriculum: The Legal Aspects of the Common Core Standards, Race to the Top, and Conditional Waivers*, 13 ENGAGE 13, 13 (2012), [http://www.fed-soc.org/doclib/20120216\\_EitelTalbertEngage13.1.pdf](http://www.fed-soc.org/doclib/20120216_EitelTalbertEngage13.1.pdf) (citing 20 U.S.C. § 1232a (2012)).



curriculum, program of instruction, administration, or personnel of any educational institution . . . .”<sup>21</sup> This current statute was based on similar language created at the inception of federal aid in higher education in 1958.<sup>22</sup>

In essence, the Department cannot regulate the quality of education because Congress has delegated that power to third-party accreditors and state regulators.<sup>23</sup> This forms the framework for federal oversight and explains why the Department has limited power to restrict institutional access to financial aid funds based on the quality of education.

### **B. Congress Expands Student Loan Funding**

Congress further developed this concept of federal aid for postsecondary education through the National Defense Education Act of 1958 (NDEA).<sup>24</sup> This was the precursor to the Perkins Loan Program.<sup>25</sup> Unlike the G.I. Bill, the NDEA provided assistance regardless of a student’s military or veteran status.<sup>26</sup> It provided low interest loans to students who studied math and science<sup>27</sup> to improve the United States’ competitiveness in the space race.<sup>28</sup>

---

<sup>21</sup> *Id.*

<sup>22</sup> See National Defense Education Act of 1958, Pub. L. No. 85-864, § 102, 72 Stat. 1580, 1582 (codified as amended at 20 U.S.C. § 1232a).

<sup>23</sup> H.R. REP. NO. 112-177, at 19 (“Because of concern about federal interference in school operations, curriculum, and instruction, the Department of Education . . . has relied on accrediting agencies and States to determine and enforce standards of program quality.”).

<sup>24</sup> See National Defense Education Act of 1958, Pub. L. No. 85-864, 72 Stat. 1580 (codified as amended in scattered sections of 20 U.S.C.).

<sup>25</sup> See *id.* (forming the loan program for qualifying students studying science and engineering, later relabeled the Perkins Loan Program); Higher Education Amendments of 1992, Pub. L. No. 102-325, § 461, 106 Stat. 448, 576 (codified as amended at 20 U.S.C. § 1087aa (2012)).

<sup>26</sup> Congress recognized that promoting science would benefit national defense. See National Defense Education Act of 1958 § 101, 72 Stat. at 1581.

<sup>27</sup> See National Defense Education Act of 1958 §§ 204, 205, 72 Stat. at 1584–86.

<sup>28</sup> See generally Roger Roots, *The Student Loan Debt Crisis: A Lesson in Unintended Consequences*, 29 SW. U. L. REV. 501, 504 (2000) (“The first federal student loan program was enacted as a national defense measure.”).

The loan portion of the NDEA was accounted in the federal budget as a direct expense in the year the funds were disbursed.<sup>29</sup> For example, if the loan was \$100 at 3% interest, the government booked a \$100 cost on its budget the year the funds were disbursed and then booked revenues as they were repaid. This method of cash basis accounting, which was standard for the federal government at the time, made it prohibitively expensive to provide student loans to students because it had the same budgetary treatment as a grant program.<sup>30</sup>

The problem with the NDEA program was that it required Congress to appropriate large initial funds in the budget, on an ongoing basis, to pay for the disbursement of loans—even when officials were reasonably sure that the programs would eventually cost much less as a result of repayments. For example, if 10 students each have a \$100 loan—for a total of \$1000 in loans— then the cost to the government would be \$1000 during the first year. However, assuming an interest rate of 3% and no defaults, the actual return after 10 years would be around \$1350. Thus, the \$1000 budgetary cost in the first year would become a surplus of \$350 at the end of the tenth year. Public policy officials realized that a different funding approach was needed to expand access and reduce costs.

Congress and the Johnson administration found their budgetary work-around in the Higher Education Act of 1965. This act served as the turning point where the federal government opened financial aid to all students regardless of their area of study or previous military service.<sup>31</sup> The Act sought to expand access to higher education through programs of grants and loans,<sup>32</sup> such as the Guaranteed Student Loan Program (GSLP). This provided an innovative compromise as a gap-filler for any student's financial need beyond grants while also

---

<sup>29</sup> *Federal Student Loan Programs History*, NEW AMERICAN FOUNDATION, <http://febp.newamerica.net/background-analysis/federal-student-loan-programs-history> (last visited May 15, 2013).

<sup>30</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO HRD-91-144BR, STUDENT LOANS: DIRECT LOANS COULD SAVE MONEY AND SIMPLIFY PROGRAM ADMINISTRATION 2 (Sept. 1991) [hereinafter 1991 GAO REPORT].

<sup>31</sup> See Higher Education Act of 1965 Pub L. No. 89-329, 79 Stat. 1219 (codified as amended in scattered sections of 20 U.S.C.); see also 20 U.S.C. §§ 1070–1099e (2012).

<sup>32</sup> See Higher Education Act of 1965 Pub L. No. 89-329, 79 Stat. 1219; *id.* at §401 (creating the Educational Opportunity Grant Program); *id.* at §421 (creating the Guaranteed Student Loan Program).

minimizing its financial impact to the budget. The GSLP was renamed the Federal Family Education Loan (FFEL) program when the Higher Education Act was reauthorized in 1992.<sup>33</sup>

The GSLP provided federal government guarantees on loans made to students by non-government lenders; the government did not directly loan the funds.<sup>34</sup> When this program was created, any loan directly owned by the government was required to be placed on the balance sheet as an expense until repaid.<sup>35</sup> A 1991 Government Accountability Office report explains the budgetary rational for adopting this approach:

A direct loan's cost was equivalent to the outlay for loan principal. Subsequent defaults and repayments were accounted for in the year they occurred, not when the loan was made. As a result of this accounting method, direct loans appeared much more expensive than guaranteed loans.<sup>36</sup>

Thus, the GSLP was developed to mitigate the program costs in the federal budget while also incentivizing private lenders to make loans to students.<sup>37</sup>

The Educational Opportunity Grant Program, which also was considered a direct expense, was created in 1965 to provide grants to students with financial need.<sup>38</sup> This program was later renamed the Federal Pell Grant Program after Senator Claiborne Pell from Rhode Island because of his focus on higher education reform during the 1960s and 1970s.<sup>39</sup> At the time it was passed in 1965, the grant

---

<sup>33</sup> See Higher Education Amendments of 1992, Pub. L. No. 102-325, § 411(a), 106 Stat. 448, 510 (codified as amended at 20 U.S.C. 1071(c)).

<sup>34</sup> See Macchiarola & Abraham, *supra* note 3, at 97 (noting that under the FFEL Program, the federal government provided subsidies to lenders for originating federal student loans); see also DEP'T OF EDUC., STUDENT LOANS OVERVIEW—FISCAL 2012 BUDGET REQUEST S-3, S-4 (2012), <http://www2.ed.gov/about/overview/budget/budget12/justifications/s-loansoverview.pdf> [hereinafter STUDENT LOANS OVERVIEW].

<sup>35</sup> See *Federal Student Loan History*, NEW AMERICA FOUNDATION, <http://febfp.newamerica.net/background-analysis/federal-student-loan-programs-history> (last visited May 15, 2013).

<sup>36</sup> 1991 GAO REPORT, *supra* note 30, at 2.

<sup>37</sup> *Id.*

<sup>38</sup> See H.R. REP. NO. 89-1178, at 15 (1965).

<sup>39</sup> William H. Hohan, *Claiborne Pell, Ex-Senator, Dies at 90*, N.Y. TIMES, Jan 1, 2009, at A21, available at <http://www.nytimes.com/2009/01/02/us/politics/02pell.html>.

program improved access to education but also was expensive to the federal budget at cost of \$70 million per year.<sup>40</sup> In fact, for fiscal year 2012, the Office of Federal Student Aid disbursed over \$33 billion in Pell Grants to students.<sup>41</sup>

As discussed in Part I, private lenders generally do not provide loans to students because of the uncertainty that results from an inability to secure an interest to reduce risk.<sup>42</sup> To get lenders to participate in the GSLP, the government provided two separate subsidies or credit enhancements. First, the government provided guarantees against loss of principal in the event of a default.<sup>43</sup> Second, the government insulated lenders from market risk by guaranteeing lenders a set rate of return on interest.<sup>44</sup> From a budgetary standpoint, the government only had to budget for a fraction of the cost of the actual loan, which allowed the government to quickly expand the program.<sup>45</sup> It is important, however, to point out that this risk exposure was not capped and the government was still vulnerable to bad outcomes. For instance, if more students than estimated could not repay the interest or defaulted on loans, the annual risk-to-cost ratio to the federal government would increase as well.

The GSLP expanded a state-by-state non-profit cottage industry for student loans, which already provided loans to students through state programs.<sup>46</sup> Even with the credit enhancements from the federal government through the GSLP, the industry was fragmented, and it constantly struggled for more capital to make loans to students.<sup>47</sup> To

---

<sup>40</sup> See H.R. REP. NO. 89-1178, at 64.

<sup>41</sup> DEP'T OF EDUC., ANNUAL REPORT 2012 8 (2012), <http://www2.ed.gov/about/reports/annual/2012report/fsa-report.pdf> [hereinafter FSA 2012 BUDGET].

<sup>42</sup> See Friedman, *supra* note 8, at 102.

<sup>43</sup> Macchiarola & Abraham, *supra* note 3, at 97 & n.142 (“[I]f a borrower defaults on a FFEL loan, the government pays the lender ninety-seven percent of the outstanding principal . . . while the lender assumes default risk for only the remaining three percent of the loan principal.” (citation omitted)).

<sup>44</sup> *Id.* at 97 & n.143.

<sup>45</sup> 1991 GAO REPORT, *supra* note 30, at 2.

<sup>46</sup> See Bradley J. B. Toben & Carolyn P. Osolinik, *Nonprofit Student Lenders and Risk Retention: How the Dodd-Frank Act Threatens Students’ Access to Higher Education and the Viability of Nonprofit Student Lenders*, 64 BAYLOR L. REV. 158, 178–79 (2012).

<sup>47</sup> MARK WOLFE, *Legislative History of Student Loan Marketing Association*, CONG. RESEARCH SERV. CRS-1 (May 17, 1982) (“[Graduate Student Loan (GSL)] lenders, many of whom had accumulated relatively large portfolios of

alleviate this pressure and to accelerate funding, the federal government formed Sallie Mae in 1972.<sup>48</sup>

When it was created, Sallie Mae was a government sponsored enterprise (GSE) similar to Fannie Mae or Freddie Mac. Its purpose was to buy existing loans from non-profits—thus returning capital to lenders to make more loans—and package the loans into securitized investments similar to bonds.<sup>49</sup> This pooling mechanism enabled investors to invest in diversified risk pools of student loans and enabled lenders to capitalize loan assets instead of waiting ten years for repayment. Additionally, because of the principal guarantees from the GSLP, the loans could be sold and securitized at relative par value irrespective of actual loan risk. This securitization process is similar to mortgage origination.<sup>50</sup> GSEs and securitization are discussed in greater detail in Part IV. The combination of federal credit enhancements and GSE liquidity stabilized and expanded the market for student loans in higher education.

To further leverage this privatized system of student loans, Congress expanded funding for guaranteed loans to almost all students when it removed strict income requirements for loans in the Middle Income Student Assistance Act (MISAA) in 1978.<sup>51</sup> MISAA helped the federal government increase funding by 39% to \$3 billion in 1979.<sup>52</sup> As stated above, this budgetary expense only covered the estimated guarantee-cost to the federal government from private loans. Using a 2005 Congressional Budget Office (CBO) study as a reference point, a guaranteed loan of \$100 would have a subsidization cost to the

---

student loans, became increasing reluctant to commit additional funds for GSLs because of their relative lack of liquidity, long repayment schedules, and relatively high servicing costs.”).

<sup>48</sup> *Id.* (citing Education Amendments of 1972, Pub. L. No. 92-318, § 439(b)(1), 86 Stat. 235, 265 (codified as amended in scattered sections of 20 U.S.C.)).

<sup>49</sup> See Wolfe, *supra* note 47, at CRS-1.

<sup>50</sup> See Wimberg, *supra* note 5, at 190–91 (discussing the similarities between the current student loan origination process and the mortgage origination process).

<sup>51</sup> See Middle Income Student Assistance Act (MISAA), Pub. L. No. 95-566, 92 Stat. 2402 (1978) (codified as amended in scattered sections of 20 U.S.C.).

<sup>52</sup> CONG. BUDGET OFFICE, FEDERAL STUDENT ASSISTANCE: ISSUE AND OPTIONS 35 (March 1980), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/111xx/doc11178/80doc12.pdf>.

Department's budget of roughly \$15, or a 15% subsidization rate.<sup>53</sup> This freed up more capital in the annual budget to make additional student loans because a \$100 loan now only cost the federal government roughly \$15 through subsidized guarantees in the budget. Thus, \$100 budgeted for student loan costs in the federal budget could be leveraged to roughly \$666 in loans to students.<sup>54</sup> In sum, the government favored the GSLP as a way to reduce direct costs in the federal budget and expand access to student loans.

### C. Policy Issues Concerning Government Backed Loans

The new expansion of unsecured student loans also raised policy concerns from debt discharges in bankruptcies in the 1970s. Rumors of students purposefully taking on high levels of debt and then discharging that debt in bankruptcy proceedings pushed Congress to act in the late 1970s.<sup>55</sup> Congress required students to prove "undue hardship" in order to discharge recent loans.<sup>56</sup> Most courts interpreted undue hardship as a difficult standard to meet.<sup>57</sup> While this policy was

---

<sup>53</sup> CONG. BUDGET OFFICE, SUBSIDY ESTIMATES FOR GUARANTEED AND DIRECT LOAN PROGRAMS 11 (2005), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/68xx/doc6874/11-16-studentloans.pdf> [hereinafter CBO SUBSIDY ESTIMATES].

<sup>54</sup> These estimates using the 2005 subsidization rate of 15% are only to illustrate how loan costs impact the federal budget and how the estimated subsidy rate reduces the annual budget costs per loan (or increases the amount available to be loaned). As stated above, \$100 at a 15% subsidization rate;  $\$100 / .15 = \$666.66$  loans available for a government cost of \$100. *See generally*, Student Loans Overview – Fiscal Year 2014 Budget Proposal, Dep't of Educ., S-11, <http://www2.ed.gov/about/overview/budget/budget14/justifications/s-loans/overview.pdf> [hereinafter 2014 Department of Education Budget Proposal].

<sup>55</sup> Simkovic, *supra* note 1, at 612–13.

<sup>56</sup> *Id.* at 613 (citing Rafael I. Pardo & Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Educational Debt*, 74 U. CIN. L. REV. 405, 420–21 (2005)).

<sup>57</sup> *See, e.g.*, *Brunner v. New York State Higher Educ. Servs. Corp. (In re Brunner)*, 831 F.2d 395, 396 (2d Cir. 1987) (per curiam) (affirming the lower court's ruling that the bankruptcy court had discharged the appellant's student loan in error on the grounds that the appellant had failed to establish "additional circumstances" beyond an inability to pay and thus was ineligible for a discharge based on "undue hardship"); *see also* Simkovic, *supra* note 1, at 612–13 (citing Pardo & Lacey, *supra* note 56, at 185); Brendan Hennessy, Comment, *The Partial Discharge of Student Loans: Breaking Apart the All or Nothing Interpretation of 11 U.S.C. § 523(A)(8)*, 77 TEMP. L. REV. 71, 78 (2004) (noting

meant to prevent bad actors from abusing the student loan system, it also functioned as a way to improve the credit-worthiness of student loans through improved collections rights.<sup>58</sup> Thus, these unsecured loans became more secure than credit card debt or personal loans. This favorable impact to the credit-worthiness of federal loans helps explain why it originally passed and why it has not changed despite numerous pushes for reform.

The Federal Credit Reform Act (FCRA) of 1990 drastically changed the accounting treatment of student loans in the federal budget by switching all federally owned loans from cash basis accounting to accrual accounting.<sup>59</sup> In 1989, a CBO study about credit reform for accounting policies explained why guaranteed loans were preferred to direct loans because of differences in accounting treatments: “The difference in the budgetary treatment between direct loans and guaranteed loans creates a bias in favor of guarantees because their costs are deferred.”<sup>60</sup> The previous cash basis treatment was the primary reason Congress switched in 1965 from direct loan programs<sup>61</sup> through the National Defense Education Act, now the Perkins Loan Program,<sup>62</sup> to the Guaranteed Loan Program, now the FFEL Program.<sup>63</sup> The FCRA defines the cost of a direct loan through a net-present-value—discounted cash flow—calculation.<sup>64</sup> This essentially allows an agency to account for the expected return or cost at the time of the disbursement, thus reducing the budgetary impact for

---

that a majority of jurisdictions have adopted the standards articulated in *Brunner* for determining “undue hardship”).

<sup>58</sup> Simkovic, *supra* note 1, at 609; see CONSUMER FINANCIAL PROTECTION BUREAU, PRIVATE STUDENT LOAN REPORT, 70–71 (2012), [http://files.consumerfinance.gov/f/201207\\_cfpb\\_Reports\\_Private-Student-Loans.pdf](http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf).

<sup>59</sup> See Federal Credit Reform Act of 1990, Pub. L. No. 101-508, tit. V, 104 Stat. 1388-610 (codified as amended at 2 U.S.C. §§ 661a–661f (2012)); see also CBO SUBSIDY ESTIMATES, *supra* note 53, at 10.

<sup>60</sup> CONG. BUDGET OFFICE, CREDIT REFORM: COMPARABLE BUDGET COSTS FOR CASH AND CREDIT xii (1989), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/67xx/doc6758/89-cbo-031.pdf>.

<sup>61</sup> *Federal Student Loan Programs History*, NEW AMERICAN FOUNDATION, <http://febp.newamerica.net/background-analysis/federal-student-loan-programs-history> (last visited May 15, 2013).

<sup>62</sup> 20 U.S.C. §§ 1087aa–1087ii (2012).

<sup>63</sup> 20 U.S.C. §§ 1071–1087-4.

<sup>64</sup> 2 U.S.C. § 661a(5)(A) (2012).

that year. This calculation and the ways in which it impacts the budget are discussed in Part IV.

The FCRA's change to accrual accounting allowed policy officials from both political parties to re-evaluate direct loan programs in order to simplify the loan process and reduce loan costs to the budget. Congress, with support from President George H. W. Bush's administration, created a pilot program for direct loans as result of the FCRA accounting treatment change.<sup>65</sup> While small in size, it allowed the Department to book favorably the expected return on investment at the time of the disbursement. In his first year of office, President Clinton converted this pilot program into what is now called the Direct Loan Program.<sup>66</sup>

While it was clear that the Direct Loan Program reduced budgetary costs, the program had limited success during the 1990s and early 2000s. During that time, direct loans initially rose to 35% but eventually fell to roughly 25% of all federal student loans.<sup>67</sup> The program was under-utilized because institutions could choose between FFEL and Direct Loan programs and Republican lawmakers favored FFEL programs by providing favorable terms for loan guarantee payments.<sup>68</sup> Additionally, private lenders and financial aid officers of universities were accused of being involved in kickback schemes to funnel students to private and FFEL loans as opposed to direct loans.<sup>69</sup>

In 2007, the College Cost Reduction and Access Act (CCRAA) diminished the FFEL program by changing the financial compensation

---

<sup>65</sup> See *A History of Direct Loans*, FEDERAL STUDENT AID—DEP'T OF EDUC., [http://www.ifap.ed.gov/dlfsheets/doc0006\\_bodyoftext.htm](http://www.ifap.ed.gov/dlfsheets/doc0006_bodyoftext.htm) (last visited Oct. 24, 2013); see also Higher Education Amendments of 1992, Pub. L. No. 102-325, § 451, 106 Stat. 448, 569–76; Robert Shireman, *Straight Talk on Student Loans*, CTR. FOR STUDIES IN HIGHER EDUC.—U. CAL. BERKELEY 5 (2004), <http://cshe.berkeley.edu/publications/docs/ROP.Shireman.Loans.10.04.pdf> (“Congress, prompted by a memo leaked from the Bush administration that indicated direct loans would be less costly and simpler to administer than guaranteed loans, responded by creating a pilot program of direct student loans.”).

<sup>66</sup> See Shireman, *supra* note 65, at 5.

<sup>67</sup> *Id.* at 6.

<sup>68</sup> *Id.* at 6–7.

<sup>69</sup> See *Special Report: Student Loan Scandal*, NEW AMERICA FOUNDATION, [http://education.newamerica.net/special\\_report\\_student\\_loan\\_scandal](http://education.newamerica.net/special_report_student_loan_scandal) (last visited May 15, 2013) (providing a comprehensive list of news articles, investigative studies and opinion pieces from 2006 to 2008).



for private lenders and servicers.<sup>70</sup> It reduced the amount of principal guaranteed by the government and also reduced the fees and interest rate subsidies to lenders.<sup>71</sup> The result of this policy was to make FFEL loans less profitable to private lenders, which correspondingly reduced the market of student loan lenders. The financial crisis demonstrated weaknesses in the FFEL program because of its dependence on private lenders to provide capital for student loans.<sup>72</sup> In the fall of 2008, banks and other lenders were having trouble finding enough capital to lend to students for the fall semester.<sup>73</sup>

To recapitalize the lenders, President George W. Bush and Congress enacted the Ensuring Continued Access to Student Loan Act of 2008 (ECASLA) to buy FFEL loans from private lenders.<sup>74</sup> Congress granted authority to the Department, which utilized complex financial structures, such as put-options and asset buying conduits, to repurchase interests in approximately \$100 billion of FFEL loans.<sup>75</sup> This amounted to a cash infusion by the government into the FFEL loan market to provide the needed capital to continue disbursing loans.<sup>76</sup> This raised serious questions about the rationale of using private capital in the first place if bankers could not find funds for federally guaranteed student loans.<sup>77</sup>

---

<sup>70</sup> See College Cost Reduction and Access Act, Pub. L. No. 110-84, 121 Stat. 784 (2007) (codified as amended in scattered sections of 20 U.S.C.); H.R. REP. NO. 110-317, at 45–47 (2007) (summarizing the changes to the FFEL program for interest rates and increased origination fees).

<sup>71</sup> H.R. REP. NO. 110-317, at 45–47.

<sup>72</sup> See Jason Delisle, *Student Loan Purchase Programs Under the Ensuring Continued Access to Student Loans Act of 2008*, NEW AMERICA FOUNDATION 1 (Dec. 2009), [http://education.newamerica.net/sites/newamerica.net/files/policy\\_docs/Student\\_Loan\\_Purchase\\_Programs\\_Under\\_ECASLA.pdf](http://education.newamerica.net/sites/newamerica.net/files/policy_docs/Student_Loan_Purchase_Programs_Under_ECASLA.pdf) [hereinafter *ECASLA Programs*].

<sup>73</sup> *Id.*

<sup>74</sup> See U.S. DEPT. ED., ENSURING CONTINUED ACCESS TO STUDENT LOANS ACT OF 2008 (ECASLA): ANNUAL REPORT TO CONGRESS 3 (2011), <http://studentaid.ed.gov/sites/default/files/fsawg/datacenter/library/July2011ECASLAREport.pdf>; Ensuring Continued Access To Student Loans Act Of 2008, Pub. L. No. 110-227, 122 Stat. 740 (codified as amended in scattered sections of 20 U.S.C.).

<sup>75</sup> *ECASLA Programs*, *supra* note 72, at 3.

<sup>76</sup> *Id.* at 1.

<sup>77</sup> Imagine the doomsday scenario where students cannot get loans to pay for tuition and universities do not receive funds. That would remove tens of billions

The CCRAA also planted two seeds that have laid the foundation for alleviating student loan debt: the Income-Based Repayment (IBR)<sup>78</sup> and Public Service Loan Forgiveness (PSLF)<sup>79</sup> programs. IBR allows any student after 2009 with direct or FFEL loans to pay only 15% of their discretionary income towards the monthly payment and extends the term of the loan to 25 years.<sup>80</sup> If there is a balance after 25 years, then that debt is cancelled and fully booked as income in the year of cancellation.<sup>81</sup> PSLF forgives only direct loan debt if the student works full-time at a qualifying public service job for 120 months—ten years.<sup>82</sup> A student can utilize the IBR plan for those ten years to reduce the monthly payment obligation and the forgiveness bypasses any taxable income from cancelled debt.<sup>83</sup>

Neither of these concepts were new to federal aid programs. The Student Loan Reform Act of 1993 offered an income contingent repayment plan.<sup>84</sup> The original NDEA program from 1958 also had loan forgiveness provisions for public school teachers.<sup>85</sup> The CCRAA, however, simplified the requirements and expanded the number of people who could qualify for these programs. These changes were possible because the federal government owned the loans from the Direct Loan Program and had broader discretion to change the repayment conditions. As discussed later, this is a powerful public policy tool that provides great flexibility but also raises significant risks to predicting the long-term cost of federal student loans.

---

of dollars from the economy in one fell swoop and probably cause debt defaults or bankruptcies for some universities.

<sup>78</sup> College Cost Reduction and Access Act, Pub. L. No. 110-84, § 493C, 121 Stat. 784, 792–95 (2007).

<sup>79</sup> College Cost Reduction and Access Act § 401, 121 Stat. 784, 800–01.

<sup>80</sup> See 20 U.S.C. § 1098e (2012); 34 C.F.R. § 682.215(b)(1) (2013).

<sup>81</sup> See I.R.C. § 108 (2013) (income provision for the cancellation of debt).

<sup>82</sup> See 20 U.S.C. § 1087e(m); 34 C.F.R. § 685.219.

<sup>83</sup> FEDERAL FINANCIAL AID—U.S. DEP'T OF EDUC., PUBLIC SERVICE LOAN FORGIVENESS Q & AS FOR BORROWERS 1 (2012), <http://www.studentaid.ed.gov/sites/default/files/public-service-loan-forgiveness-common-questions.pdf>.

<sup>84</sup> Student Loan Reform Act of 1993, Pub. L. No. 103-66, § 455(e), 107 Stat. 341, 349–50 (codified as amended at 20 U.S.C. § 1087e (2012)).

<sup>85</sup> See CONG. BUDGET OFFICE, STUDENT LOAN FORGIVENESS PROGRAMS CRS-1 (April 1, 2005), [http://assets.opencrs.com/rpts/RL32516\\_20040809.pdf](http://assets.opencrs.com/rpts/RL32516_20040809.pdf).

## D. Current Programs

### 1. Student Aid and Fiscal Responsibility Act of 2010

With the ECASLA program fresh in the background, President Obama and Congress enacted the Student Aid and Fiscal Responsibility Act of 2010 (SAFRA),<sup>86</sup> which was a significant change in student loan policy. Under SAFRA, the Department was required to eliminate FFEL programs by 2010 and replace all federal student loans with the Direct Loan Program.<sup>87</sup> Citing the FCRA accounting changes as the basis for its analysis, the CBO stated that this change to only direct lending would save the federal budget “\$28 billion over the 2010–2014 period and \$58 billion over the 2010–2019 period.”<sup>88</sup>

More recently, the CBO estimated savings for fiscal years 2013 and 2014 of \$35 billion and \$34 billion, respectively.<sup>89</sup> In addition to this change to direct lending, the government further expanded the PLSF and IBR programs enacted in 2007. The Pay As You Earn (PAYE) option reduced the IBR monthly payment to only 10% of discretionary income and shortened the repayment period to twenty instead of twenty-five years for new borrowers after October 1, 2007.<sup>90</sup> These payment changes were possible because they were tied to the savings from the switch to direct lending. The Direct Loan Program comprised about 30% of all student loans at the time SAFRA was

---

<sup>86</sup> Student Aid and Fiscal Responsibility Act (SAFRA), Pub. L. No. 111-152, tit. II, sub. A, 124 Stat. 1071 (2010).

<sup>87</sup> CONG. RESEARCH SERV. OFFICE, THE SAFRA ACT: EDUCATION PROGRAMS IN THE FY2010 BUDGET RECONCILIATION 1–2 (2010), <http://www.aacc.nche.edu/Advocacy/Documents/CRS%20SAFRA.pdf>.

<sup>88</sup> Letter from Douglas Elmendorf, Director, Congressional Budget Office, to Nancy Pelosi, Speaker, U.S. House of Representatives, 6 (Mar. 20, 2010), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/113xx/doc11379/amendreconprop.pdf> (filed on CBO website).

<sup>89</sup> CONG. BUDGET OFFICE, CBO FEBRUARY 2013 BASELINE PROJECTIONS FOR THE STUDENT LOAN PROGRAM Table 1 (2013), [http://www.cbo.gov/sites/default/files/cbofiles/attachments/43913\\_StudentLoans.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/43913_StudentLoans.pdf).

<sup>90</sup> *See generally* 20 U.S.C.A. § 1087e(m) (2012); 34 C.F.R. § 685.219 (2013); 34 C.F.R. 685.209(a)(1)(iii) (New borrowers are defined as any student that did not have outstanding loans before October 1, 2007 which received any Direct Loan disbursements after October 1, 2011).

enacted, and the program rapidly expanded.<sup>91</sup> During fiscal year 2012, the Department loaned \$142 billion exclusively through direct loans.<sup>92</sup>

## 2. Student Loan Certainty Act of 2013

In a rare act of bipartisanship, Congress passed the Bipartisan Student Loan Certainty Act (SLCA) in August 2013.<sup>93</sup> The legislation was signed into law by President Obama on August 9, 2013, and was retroactively effective on July 1, 2013.<sup>94</sup> This legislation changed the interest rates of student loans from statutorily set interest rates of 6.8%, for undergraduates and Stafford Graduate loans, and 7.9%, for parent loans and Plus loans for graduates, to a more flexible fixed rate based on the market rate of 10-Year Treasury Notes sold that year. The following chart compares the impact of the new legislation to previous loan rates:

	Before SLCA <sup>95</sup> (2006-2013)	SLCA Rate <sup>96</sup>	Rates 2013-2014 <sup>97</sup>	SLCA Cap on Fixed Rate <sup>98</sup>
Undergraduate	6.8% (3.4% from 2011–2013)	2.05% + 10- Year Rate	3.86%	8.25%
Graduate Student Stafford	6.8%	3.6% + 10- Year Rate	5.41%	9.5%
PLUS Loans (Graduate & Parent)	7.9%	4.6% + 10- Year Rate	6.41%	10.5%

<sup>91</sup> *Student Loans Overview*, *supra* note 34, at S-13 (New Student Loan Volume During 2009).

<sup>92</sup> *See, e.g.*, U.S. DEP'T OF EDUCATION, FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 57 (2012), <http://www2.ed.gov/about/reports/annual/2012report/agency-financial-report.pdf>. This number includes consolidations through SAFRA, without the consolidations the government disbursed \$105 billion to 11 million students. FSA 2012 BUDGET, *supra* note 41, at 9.

<sup>93</sup> *See generally* 20 U.S.C. § 1098e(b)(7)–(8).

<sup>94</sup> *See* 20 U.S.C. § 1087e(b)(8).

<sup>95</sup> 20 U.S.C. § 1087e(b)(7).

<sup>96</sup> 20 U.S.C. § 1087e(b)(8).

<sup>97</sup> *Calculators & Interest Rates*, U.S. DEP'T OF EDUC.—FEDERAL STUDENT AID, <http://www.direct.ed.gov/calc.html> (last visited Aug. 9, 2013).

<sup>98</sup> 20 U.S.C. § 1087e(b)(8).

The legislation was a response to the return of higher undergraduate interest rates, previously set at 3.4% from July 2011 to July 2013, to 6.8%.<sup>99</sup> The immediate effect was to lower the interest rates for all new disbursements during the 2013–2014 academic year. The SLCA also introduced market-pricing to student loans by allowing the possibility for interest rates to go up to 8.25% for undergraduates, 9.5% for some graduate loans, and 10.5% for parent and some graduate loans.<sup>100</sup> The interest rate cap of 8.25% for loan consolidation was removed to allow for the potentially higher market-based rates on loans in the future.<sup>101</sup> In essence, the SCLA reduced the long-term risk of inflation—i.e., increased Treasury Note rates—for student loans originated by the federal government while also providing a short-term reduction in interest rates for current students. The SLCA required the Government Accountability Office to perform a detailed study to determine “the actual cost to the Federal Government of carrying out the Federal student loan programs.”<sup>102</sup> The law also requires a separate cost breakdown of loan administrative costs, interest rates, and other terms.<sup>103</sup>

Despite the relatively short history of federal student loans, two policy trends are evident. First, the method of lending money to students is predicated almost entirely on the budgetary treatment of the program. The FFEL program was created in the Higher Education Amendments of 1965 to reduce the budgetary impact of NDEA loans to expand access to more students at a lower cost. The Direct Loan Program of 1993 was only created after the accounting changes of FCRA in 1990. President Obama’s push for an exclusive Direct Loan Program, with its flexible repayment plans, was due primarily to the program’s positive impact on the budget.<sup>104</sup> SLCA reduced current

---

<sup>99</sup> See Equal Justice Works, *Student Loan Act Could Mean Higher Federal Profits*, U.S. NEWS (Aug. 14, 2013), <http://www.usnews.com/education/blogs/student-loan-ranger/2013/08/14/student-loan-act-could-mean-higher-federal-profits>; 20 U.S.C. § 1087e(b)(7)(D)(v).

<sup>100</sup> 20 U.S.C. § 1087e(b)(8).

<sup>101</sup> § 1087e(b)(8)(D).

<sup>102</sup> See Bipartisan Student Loan Certainty Act of 2013, Pub. L. No. 113-28, 127 Stat. 506, § 4.

<sup>103</sup> *Id.*

<sup>104</sup> Peter Baker & David M. Herszenhorn, *Obama Signs Overhaul of Student Loan Program*, N.Y. TIMES (Mar. 30, 2010), <http://www.nytimes.com/2010/03/31/us/politics/31obama.html>. See generally Jonathan D. Glater, *The Other Big Test*:

interest rates for students by allowing increases in the future based on market-based rates.<sup>105</sup> Second, the government fills an important need—not met by private lenders because of risk—by providing loans to students either directly or through credit enhancements to prevent underinvestment of human capital.<sup>106</sup>

Based on this historical analysis, any discussion about reforming student loans must revolve around its impact to the budget. If policy makers want to change student loan policies, they must change how such programs are accounted through FCRA and make adjustments to risk analysis.

### III. GOVERNMENT RISKS

There are two general policy issues confronting current student loan programs. First, the loan programs have placed an inordinate amount of risk with the federal government. The programs have burdened the federal balance sheet with roughly \$1 trillion in risky student loan debt. For the annual budget, the programs inaccurately reduce costs through inflated negative subsidies<sup>107</sup> that do not fully encompass the true cost of the lending programs. Second, the federal government, through the triad of quality education regulators and failed Gainful Employment Regulations,<sup>108</sup> has been incapable of closing the educational quality feedback loop between uninformed

---

*Why Congress Should Allow College Students to Borrow More Through Federal Aid Programs*, 14 N.Y.U. J. LEGIS. & PUB. POL'Y 11, 58–59 (2011) (asserting that direct funding from the federal government would allow the government to retain control over the loans and institute flexibility in the repayment options).

<sup>105</sup> See 20 U.S.C. § 1087e(b)(8) (tying interest rates for various loans to the ten-year treasury bond rate plus an additional percentage).

<sup>106</sup> See FRIEDMAN, *supra* note 8, at 102.

<sup>107</sup> The term “negative subsidy” is used in the federal budget to describe a program that returns more money to the program than the cost allocated. Hence, a real subsidy is the actual budgetary cost of a program to the federal government whereas a negative subsidy is the amount added to the federal budget from the program. In layman terms, a negative subsidy is the fictional “profit” from the program which can be used to offset other costs, such as increased Pell Grants. See generally, 2014 Department of Education Budget Proposal, *supra* note 54 at S-11.

<sup>108</sup> Gainful Employment Regulations encompass the regulations set forth by the Secretary of Education so that educational institutions can receive federal funds. See generally 34 C.F.R. § 668.8 (2013) (providing reporting regulations for schools regarding gainful employment statistics).

students, federal student loans, and academic institutions that bear minimal risk for such loans. This transfers the risk of providing a quality education to the federal government even though the government is restricted in its ability to regulate academic institutions for quality.

Legal scholars<sup>109</sup> aptly have outlined other problems with student loan programs, such as students being burdened with greater student loan debt as a result of higher tuition costs.<sup>110</sup> This increase in tuition costs is prevalent especially in the for-profit sector of higher education.<sup>111</sup> While there are many factors at play, this increase can be attributed to inadequate incentives for institutions to control their program costs. Former U.S. Department of Education Secretary William Bennett proffered a similar explanation for the continued tuition increases.<sup>112</sup> He suggested that federal aid allows tuition

---

<sup>109</sup> See, e.g., Wimberg, *supra* note 5, at 194 (citing Daniel L. Bennett, *New College Loan Rules Put Taxpayers at Risk*, FORBES.COM (May 10, 2010, 6:00 PM), <http://www.forbes.com/2010/05/10/student-loans-safra-leadership-education-bennett.html>) (taxpayer investment in the financial aid programs are failing to produce societal benefits); Roots, *supra* note 28, at 511–12 (stating that few people would deny that federal aid is directly responsible for the rising costs of college education).

<sup>110</sup> See *Tuition Costs of Colleges and Universities*, NATIONAL CENTER FOR EDUC. STATISTICS, <http://nces.ed.gov/fastfacts/display.asp?id=76> (last visited Apr. 5, 2013).

<sup>111</sup> See, e.g., Jean Braucher, *Mortgaging Human Capital: Federally Funded Subprime Higher Education*, 69 WASH. & LEE L. REV. 439, 457–58 (2012) (citations omitted) (noting that students who attend for-profit colleges are burdened with higher debts and default rates than those students who attend public or nonprofit institutions); Amanda Harmon Cooley, *The Need for Legal Reform of the For-Profit Educational Industry*, 79 TENN. L. REV. 515, 528–29 (2012) (citations omitted) (highlighting the exploitive practices engaged in by for-profit institutions coupled with the for-profit students' heightened loan debt and diminished employment prospects).

<sup>112</sup> William J. Bennett, Opinion, *Our Greedy Colleges*, N.Y. TIMES, Feb. 18, 1987, [http://www.nytimes.com/1987/02/18/opinion/our-greedy-colleges.html?page\\_wanted=all&src=pm](http://www.nytimes.com/1987/02/18/opinion/our-greedy-colleges.html?page_wanted=all&src=pm) (“If anything, increases in financial aid in recent years have enabled colleges and universities [to blithely] raise their tuitions, confident that Federal loan subsidies would help cushion the increase.”). *But see generally* ANDREW GILLEN, *FINANCIAL AID IN THEORY AND PRACTICE: WHY IT IS INEFFECTIVE AND WHAT CAN BE DONE ABOUT IT* (2009), [http://www.centerforcollegeaffordability.org/uploads/Financial\\_Aid\\_in\\_Theory\\_and\\_Practice%281%29.pdf](http://www.centerforcollegeaffordability.org/uploads/Financial_Aid_in_Theory_and_Practice%281%29.pdf) (critiquing William Bennett’s theory as too broad because it treats all federal financial aid as equal causes of rising tuition costs).

inflation to occur because the federal government provides aid in the form of grants and loans to match the costs of education and the institutions have little incentive to rein in costs.<sup>113</sup> In other words, there is a break down in incentives to institutions because they do not substantially bear the risk of unsuccessful educational outcomes for students such as when the student does not repay the debt. While there are other problems with student loans, budget risks and closing this feedback loop on educational quality require further examination to produce successful reforms in which all actors in higher education will have similarly aligned incentives for positive educational outcomes.

### **A. Federal Accounting and Budget Risks**

This section will address in greater detail how the federal budget currently impacts student loan policy and, conversely, how student loans may impact the budget. This section will analyze the following: (1) how accrual accounting impacts the federal budget and its potential pitfalls; (2) two looming issues for financial aid: fair-value accounting and impending costs or write-downs; and (3) how to reduce accounting and write-down risks through changes in public policy.

The current federal structure for student loans differs from most government assistance programs. By more than a two-to-one margin, the government has preferred loan guarantee programs over direct ownership of loan obligations.<sup>114</sup> The government provides loan guarantees in the following markets: residential mortgages through FHA loans and VA loans; small businesses through SBA loans; and various loan programs for international trade.<sup>115</sup> Of the direct loans and guarantees programs, student loans have the largest percentage of negative subsidies due to the way the costs are calculated through FCRA.<sup>116</sup> In fiscal year 2012, student loans from the Direct Loan Program comprised 78% of all credit receivables—\$673 billion out of

---

<sup>113</sup> See Bennet, *supra* note 112; see also William S. Howard, *The Student Loan Crisis and the Race to Princeton Law School*, 7 J. OF L. ECON. & POLICY 485, 496–97 (2011) (describing higher education as an inelastic good which is not effected by price increases).

<sup>114</sup> U.S. TREASURY DEP'T, 2012 FINANCIAL REPORT OF THE U.S. GOVERNMENT 67–68 (2012), <http://www.fms.treas.gov/fr/12frusg/12frusg.pdf> [hereinafter 2012 U.S. FINANCIAL REPORT].

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*



\$859 billion—on the federal balance sheet.<sup>117</sup> In the same year, the number of student loans managed by the federal government ballooned to \$948 billion<sup>118</sup> with loans to 38 million individuals.<sup>119</sup> These loans are considered an asset on the federal balance sheet with the estimated repayments comprising roughly 30% of the federal government's assets.<sup>120</sup> Student loans, once an afterthought with restricted funding, are now the focus of fiscal and public policy debates because of their impact on the overall federal budget.

#### 1. Accrual Accounting & Fair-Value Estimates for Direct Loans

As stated in Part II, the most significant recent change in federal student aid was the FCRA, which mandated accrual accounting for credit programs.<sup>121</sup> The FCRA requires the government to record the lifetime cost of federal credit programs, such as federal student loans, on an up-front accrual basis.<sup>122</sup> For the purposes of budgeting the cost of student loans, this means that the Department must estimate the long-term costs of the loan when it is first disbursed.<sup>123</sup> The FCRA defines the cost for a federal credit program, such as a student loan, as the “estimated long-term cost to the Government of a direct loan or loan guarantee . . . calculated on net present value basis, excluding administrative costs and any incidental effects on governmental receipts or outlays.”<sup>124</sup>

---

<sup>117</sup> *Id.*

<sup>118</sup> *FSA 2012 Budget*, *supra* note 41, at 77.

<sup>119</sup> *Id.* at 9.

<sup>120</sup> 2012 U.S. FINANCIAL REPORT, *supra* note 114, at iv.

<sup>121</sup> See Federal Credit Reform Act of 1990, Pub. L. No. 101-508, tit. V, 104 Stat. 1388-610 (codified as amended at 20 U.S.C. §§ 661(a)–(f) (2012)); *Federal Student Loan Cost Estimates*, NEW AMERICA FOUNDATION, <http://febp.newamerica.net/background-analysis/federal-student-loan-cost-estimates> (last visited Nov. 10, 2013) [hereinafter *Federal Student Loan Estimates*].

<sup>122</sup> CONG. BUDGET OFFICE, FAIR-VALUE ESTIMATES OF THE COST OF FEDERAL CREDIT PROGRAMS IN 2013 2 (2012), [http://cbo.gov/sites/default/files/cbofiles/attachments/FairValue\\_One-Col.pdf](http://cbo.gov/sites/default/files/cbofiles/attachments/FairValue_One-Col.pdf).

<sup>123</sup> James M. Bickley, *Budgetary Treatment of Federal Credit (Direct Loans and Loan Guarantees): Concepts, History, and Issues for the 112th Congress*, CONG. RESEARCH SERV. 1 (Jul. 27, 2012), <http://www.fas.org/sgp/crs/misc/R42632.pdf>.

<sup>124</sup> 2 U.S.C. § 661a(5)(A) (2012).

This is a form of accrual accounting in two ways: (1) the government estimates on a regular basis its expected future payments minus doubtful accounts; and (2) the estimated loss/gain is discounted to a present value based on a discount rate. The estimated cost is then translated into the annual budget as a subsidy. If the estimated loan payments are more than the estimated cost, then this is referred to in the federal budget as a negative subsidy.<sup>125</sup> Currently, for every \$1 loaned to a student, the federal government expects to receive \$1.32 in repayment, \$.32 of which is a negative subsidy.<sup>126</sup> Below is a list created by the CBO and compiled by the New America Foundation of subsidy cost estimates for fiscal year 2013 showing an overall negative subsidy of \$36.5 billion:<sup>127</sup>

**Federal Student Loan Volume and Subsidy Cost Estimates,  
Fiscal Year 2013<sup>128</sup>**

Loan Type	Subsidy Rate	New Volume (billions)	Costs (billions)
Subsidized Stafford Loans	-15.1%	\$30.4	-\$4.6
Unsubsidized Stafford Loans	-33.8%	\$60.9	-\$20.6
GradPLUS Loans	-57.8%	\$9.1	-\$5.3
Parent PLUS Loans	-49.8%	\$12.3	-\$6.1
Total	-32.4%	\$112.7	-\$36.5

<sup>125</sup> STUDENT LOANS OVERVIEW, *supra* note 34, at S-7 (“A negative subsidy occurs when the present value of cash inflows to the Government is estimated to exceed the present value of cash outflows. In that case, the Federal Government is earning more than it is spending.”).

<sup>126</sup> *Federal Student Loan Estimates*, *supra* note 121; *see also* Memorandum from Congressional Budget Office titled March 2012 Baseline Budget Account Totals, CONG. BUDGET OFFICE (Mar. 13, 2012), [http://cbo.gov/sites/default/files/cbofiles/attachments/43054\\_StudentLoanPellGrantPrograms.pdf](http://cbo.gov/sites/default/files/cbofiles/attachments/43054_StudentLoanPellGrantPrograms.pdf).

<sup>127</sup> *Federal Student Loan Estimates*, *supra* note 121.

<sup>128</sup> *Id.*

The FCRA calculation also discounts the future cash flows into present dollar terms. A net present value calculation is based on the theory that money today is more valuable than money in the future; thus, future cash flows are discounted to compensate for the cost of borrowing, riskiness of the investment, and other factors.<sup>129</sup> Under the FCRA, the present value of future cash flows can be calculated in the following way:

$$\begin{aligned} \text{Present Value}^{130} &= \text{Total Future Payments} / \\ &\quad (1 + \text{Discount Rate})^{(\text{Number of Years})} \\ \text{Discount Rate} &= \text{Average Interest Rate on Marketable} \\ &\quad \text{Treasury Securities of Similar Maturity}^{131} \\ &\quad \text{(i.e., 10-year Treasury Notes at roughly 2\%)} \\ \text{Future Payments} &= \text{Estimated Payment of Principal, Interest} \\ &\quad \text{Accrued, Penalties, Fees, and Doubtful} \\ &\quad \text{Accounts (losses)}^{132} \end{aligned}$$

**Not Included: Market Risk of Loans,<sup>133</sup> or Administrative Costs  
(including collections costs) of loan programs<sup>134</sup>**

To make this calculation, the Department fills the variables in the above net present value formula based on the loan amount, the expected repayment of principal, and the interest and other payments over the life of the loan—penalties, fees, or defaults.<sup>135</sup> Agencies must recalculate these estimates on a regular basis.<sup>136</sup>

The accounting treatment and net present value calculations have been extensively covered by the CBO, the Congressional Research

---

<sup>129</sup> CBO SUBSIDY ESTIMATES, *supra* note 53, at 10.

<sup>130</sup> See Bickley, *supra* note 123, at 18.

<sup>131</sup> 2 U.S.C. § 661a(5)(E) (2012).

<sup>132</sup> See *id.* at § 661a(5)(B).

<sup>133</sup> See Bickley, *supra* note 123.

<sup>134</sup> 2 U.S.C. § 661a(5)(A).

<sup>135</sup> See *id.* § 661a(5)(B).

<sup>136</sup> See *id.* § 661c (“There is hereby provided permanent indefinite authority for these reestimates.”).

Service (CRS), and the New America Foundation.<sup>137</sup> Based on their research, federal interest rates are the primary reason for negative subsidies for student loans.<sup>138</sup> A CRS Report explained the primary reason for the subsidy: “This high negative subsidy level was due primarily to the use of Treasury interest rates to discount future credit flows.”<sup>139</sup> In other words, the government is borrowing money at historically low levels from the Treasury Department and then charging interest on its student loans at rates ranging from 3.4% to 7.9%, plus fees. This kind of arbitrage has greatly reduced the budgetary cost of student loans.

Instead of using the treasury rate for the discount rate, experts have pushed for assigning a discount rate based on the market risk of the loans—in other words, the risk of default.<sup>140</sup> The inclusion of the administrative costs for servicing loans would also reduce the negative subsidy and more accurately reflect the cost of the programs.<sup>141</sup> These reforms to the FCRA formula sometimes are referred to as Fair-Value Estimates.<sup>142</sup> Republican House Representatives have unsuccessfully attempted to reform the FCRA in the 2014 Budget by proposing the adoption of fair-value accounting principles.<sup>143</sup> The SLCA further demonstrated this push for fair-value accounting for federal student loans by using market-based interest rates and commissioning a Government Accountability Office study to provide an accurate estimate of student loan costs, including administrative costs.<sup>144</sup> As such, it appears the current FCRA method of calculating subsidies is

---

<sup>137</sup> CBO SUBSIDY ESTIMATES, *supra* note 53, at 10; *Federal Student Loan Estimates*, *supra* note 121; Bickley, *supra* note 123, at 13.

<sup>138</sup> See, e.g., Bickley, *supra* note 123, at 15.

<sup>139</sup> *Id.*

<sup>140</sup> *Federal Student Loan Estimates*, *supra* note 121.

<sup>141</sup> CONG. BUDGET OFFICE, FAIR-VALUE ACCOUNTING FOR FEDERAL CREDIT PROGRAMS 10–11 (2012), [http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-05-FairValue\\_Brief.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-05-FairValue_Brief.pdf) [hereinafter FAIR-VALUE ACCOUNTING].

<sup>142</sup> *Id.*

<sup>143</sup> *The Path to Prosperity: A Responsible Balanced Budget*, U.S. HOUSE OF REPS. 51 (Mar. 2013), <http://budget.house.gov/uploadedfiles/fy14budget.pdf> (discussing the use of fair-value scoring to properly evaluate taxpayer risk from government backed housing loans).

<sup>144</sup> Bipartisan Student Loan Certainty Act of 2013, Pub. L. No. 113-28, 127 Stat. 506, § 4.

beginning to be confronted by Congress and will require re-estimates of costs and subsidies or eventual unbudgeted write-downs.

## 2. Underestimated Costs of Programs and Increased Treasury Rates

There are two looming issues that could seriously impact the federal student loan cost structure which have not properly been taken into account through the FCRA. First, new federal programs such as IBR,<sup>145</sup> PAYE,<sup>146</sup> and PSLF<sup>147</sup> modify the repayment estimates negatively, and these changes have not been fully factored into FCRA subsidy estimates.

Pursuant to 2 U.S.C. § 661a(9), agencies are required to recalculate cash flows when a modification occurs.<sup>148</sup> This includes budgetary impacts “resulting from new legislation, or from the exercise of administrative discretion under existing law, that directly or indirectly alters the estimated cost of outstanding direct loans (or direct loan obligations) or loan guarantees (or loan guarantee commitments) such as a change in collection procedures.”<sup>149</sup>

The IBR, PAYE, and PSLF programs modified the FCRA calculations, but the Department has not fully incorporated these changes into its long-term cost estimates. For example, a number of policy experts have noted that the IBR program allows many students to take on large amounts of graduate school debt with reduced risk of repayment.<sup>150</sup> One Barclays study estimated the cost of the programs

<sup>145</sup> 20 U.S.C. § 1098e; 34 C.F.R. § 685.221 (2013).

<sup>146</sup> See, e.g., SAFRA Act, Pub. L. No. 111-152, § 2213, 124 Stat. 1071, 1081 (2010) (amending 20 U.S.C. § 1098e (2008)) (changes effective July 1, 2014); 34 C.F.R. § 685.209; *Help Americans Manage Student Loan Debt*, THE WHITE HOUSE (Oct. 25, 2011), <http://www.whitehouse.gov/the-press-office/2011/10/25/fact-sheet-help-americans-manage-student-loan-debt> (President Obama used his executive authority to move up the implementation of Pay-As-You-Earn to starting in 2012 with any loans disbursed after October 1, 2007).

<sup>147</sup> 20 U.S.C. § 1087e(m); 34 C.F.R. § 685.219.

<sup>148</sup> 2 U.S.C. § 661a(9) (2012).

<sup>149</sup> *Id.*

<sup>150</sup> See, e.g., Kelly Edmiston, et al, *Student Loans: Overview and Issues (Update)*, FEDERAL RESERVE BANK OF KANSAS CITY 14 (Apr. 2013), <http://www.kansascityfed.org/publicat/reswkpap/pdf/rwp%2012-05.pdf>; Jason Delisle & Alex Holt, *Safety Net or Windfall? Examining Changes to Income-Based Repayment for Federal Student Loans*, NEW AMERICA FOUNDATION 11, 13 (Oct. 2012), <http://edmoney.newamerica.net/sites/newamerica.net/files/policydocs>

to be around \$300 billion over the next ten years.<sup>151</sup> The report estimated, based on research from a study by the Kansas City Federal Reserve, that roughly half of students would utilize the IBR programs, whereas the Department currently estimates that only 6% of students will do so.<sup>152</sup>

The Department has underestimated the size of the IBR program participation and has not fully recognized the cost because of overly-optimistic estimates. In 2007, when the IBR Program was introduced, the CBO estimated its cost at \$1.9 billion through 2017.<sup>153</sup> The CBO also estimated that this cost would be offset by students utilizing direct loans, which have more favorable budgetary treatment than FFEL loans.<sup>154</sup> For the new PLSF program, the Department estimated the cost to be \$2.1 billion from 2012 to 2021, or roughly \$233 million per year.<sup>155</sup>

When the annual cost estimates of the IBR and PLSF programs are combined, the cost to the U.S. taxpayers is less than \$1 billion per year and less than 1% of the estimated \$100 billion in annually disbursed loans. This cost estimate must be recalculated as it becomes clear that more students will pursue these options. Additionally, a student using the IBR hides default risk by extending the recognition event until the loan is officially cancelled after twenty to twenty-five years.<sup>156</sup>

---

/NAF\_Income\_Based\_Repayment.pdf (noting that many graduates that are not “struggling” are taking advantage of current IBR rates); Matt Leichter, *Income-Based Repayment: Lifeline for Law Graduates, Certain Loser for Government*, THE AMERICAN LAWYER (Oct. 11, 2012), [http://www.americanlawyer.com/PubArticleALD.jsp?id=1202574613758&IncomeBased\\_Repayment\\_Lifeline\\_for\\_Law\\_Graduates\\_Certain\\_Loser\\_for\\_Government](http://www.americanlawyer.com/PubArticleALD.jsp?id=1202574613758&IncomeBased_Repayment_Lifeline_for_Law_Graduates_Certain_Loser_for_Government).

<sup>151</sup> Jason Delisle, *Barclays Student Loan Report: New Income Based Repayment Enrollment to Balloon, \$235 Billion Hidden Cost*, NEW AMERICA FOUNDATION, (Dec. 13, 2012), [http://edmoney.newamerica.net/blogposts/2012/barclays\\_student\\_loan\\_report\\_new\\_income\\_based\\_repayment\\_enrollment\\_to\\_balloon\\_cost\\_75](http://edmoney.newamerica.net/blogposts/2012/barclays_student_loan_report_new_income_based_repayment_enrollment_to_balloon_cost_75).

<sup>152</sup> *Id.*

<sup>153</sup> Delisle & Holt, *supra* note 150, at 38 n.13.

<sup>154</sup> *Id.*

<sup>155</sup> Proposed Rulemaking for Student Loan Programs, 77 Fed. Reg. 42,086, 42,087, 42,122 (July 17, 2012).

<sup>156</sup> For example, if an individual earns \$10,000 per year then he or she has no obligation to make payments on his or her student loans and his or her loan balance would be cancelled after twenty years. That individual will never be delinquent or in default of his or her student loans despite never making a

The second looming budgetary risk is that the current discount rate does not reflect the riskiness of the student loans. As stated above, the primary reason for the negative subsidy for the past couple of years is that interest rates for treasury notes have been at historic lows.<sup>157</sup> The discount rate is tied to the federal treasury rates, so any increase in federal rates will correspondingly reduce the negative subsidy for direct loan programs.<sup>158</sup> Eventually, federal interest rate increases will trigger additional subsidy costs, and the government will need to allocate funding to cover such costs. If the FCRA discount rate is redefined to include the fair value of the riskiness of student loans, this also will lead to additional subsidy costs in the federal budget. Because these are unsecured loans, this change in the discount rate probably will be significant but also necessary to properly estimate the cost of the student loan programs.

The SLCA has helped reduce the budget risk of increasing federal treasury rates by tying new loan origination interest rates to increases in the 10-Year Treasury Note rates.<sup>159</sup> This legislation is a great example of an effort to use short-term federal costs to achieve long-term budget stability, and it also demonstrates the viability of student loan reform so long as it favorably impacts the budget and balance sheet. The legislation also shows the willingness of Congress to introduce a market-based pricing mechanism into the student loan market to mitigate federal risks.

The CBO estimates that the SLCA will have a short-term budgetary cost of \$8 billion and \$12 billion in 2013 and 2014, respectively.<sup>160</sup> By 2023, the SLCA is projected to save the federal government an overall \$715 million from increased student loan rates because of projected increases in 10-Year Treasury Note rates.<sup>161</sup> The real savings here is not the \$715 million projected over eleven years but rather the elimination of the budgetary uncertainty caused by

---

payment, so long as that individual submits the requisite filings under the Income-Based Repayment plan.

<sup>157</sup> Bickley, *supra* note 123, at 11.

<sup>158</sup> *See id.*

<sup>159</sup> 20 U.S.C. § 1087e(b) (2012).

<sup>160</sup> CONG. BUDGET OFFICE, CBO ESTIMATE OF THE BUDGETARY EFFECTS OF THE BIPARTISAN STUDENT LOAN CERTAINTY ACT OF 2013 (July 22, 2013), <http://www.cbo.gov/sites/default/files/cbofiles/attachments/Bipartisan%20Student%20Loan%20Certainty%20Act%20of%202013.pdf>.

<sup>161</sup> *Id.*

increases of federal interest rates for the FCRA subsidy estimate calculations.<sup>162</sup> Although this mitigates some budget risk from increased federal interest rates, the SLCA fails to tie the student loan rates to the actual riskiness of the student loans. It also does not address the inaccurate FCRA estimates for roughly \$1 trillion of student loans already in existence.

Most experts, including the CBO, agree that the government should use a fair-value approach for the accounting treatment of student loans.<sup>163</sup> Risks ranging from imprecise accounting treatments to unrecognized costs will cause significant changes in the federal balance sheet and budget. The question then becomes: who should bear this greater risk and potential cost? Additionally, are there ways to limit the cost to the government while also creating better incentives in the student loan market? The federal government should be evaluating different methods: (1) to reduce its risk exposure to almost \$1 trillion in student loans; (2) to accurately prepare budgets for future student loan costs; and (3) to use policy tools to incentivize positive educational outcomes.

## **B. Risks Stemming From a Lack of Quality Education Control**

The second policy issue confronting current student loan programs is the federal government's inability to connect the educational outcome feedback loop by tying together the interest of the students, the accreditors, the student loan originators—currently the federal government—and the regulators. This section summarizes the federal government's failed attempts to regulate educational quality and briefly analyzes alternative quality education indicator mechanisms such as risk-based pricing, put-options, and cost sharing with States.

### **1. Failed Federal Regulation of Quality Education**

From the inception of financial aid through the G.I. Bill and the Higher Education Act, the federal government has delegated quality control to states or accreditors.<sup>164</sup> In its effort to protect taxpayer

---

<sup>162</sup> See David P. Smole, *An Examination of Student Loan Interest Rate Proposals in the 113th Congress*, CONG. RESEARCH SERV. 30 (Jul. 26, 2013), <http://www.fas.org/sgp/crs/misc/R43094.pdf> (explaining how increased federal interest rates impact subsidy cost estimates and market-based rates can limit that cost).

<sup>163</sup> FAIR-VALUE ACCOUNTING, *supra* note 141, at 1.

<sup>164</sup> See discussion, *supra* Part II.A.



dollars and push education reform, the Department has occasionally focused its regulation on quality education indicators in for-profit postsecondary academic institutions. These policies have had mixed results.

Starting in the 1990s, federal regulators attempted to rein in bad acting institutions through minimal requirements to enroll students, such as the Ability to Benefit test and Cohort Default Rate regulations.<sup>165</sup> The Department's most recent foray into quality education imposed more stringent and measurable restrictions on proprietary, for-profit institutions through the 2010 Gainful Employment Regulations (GER).<sup>166</sup> The GER stated, *inter alia*, that student loan repayment rates must be at least 35% and annual repayment must be less than or equal to 30% of the borrower's discretionary income or less than or equal to 12% of annual earnings.<sup>167</sup> If the institution failed both measures for three out of four years, then it would lose access to financial aid, including loan programs.<sup>168</sup>

This attempt to regulate for-profit institutions based on learning outcomes—repayment rates based on income—was circumvented when the D.C. Circuit Court vacated the promulgated regulations in July 2012.<sup>169</sup> The Court ruled that the 35% repayment rate was not based on the agency record and was therefore arbitrary and in violation of the Administrative Procedures Act.<sup>170</sup> Although the Court vacated all of GER, the Department intends to promulgate the new rules in the

---

<sup>165</sup> See 34 C.F.R. § 668.32(e) (2012) (listing requirements for student eligibility for loan assistance, including the “ability to benefit” test); *id.* §§ 668.181–668.197, 668.200–668.217 (establishing regulations for cohort default rates).

<sup>166</sup> See generally *Gainful Employment Information*, DEP'T OF EDUCATION, <http://ifap.ed.gov/GainfulEmploymentInfo/> (last visited May 15, 2013) [hereinafter *Gainful Employment Information*] (comprehensive resource for statutes, regulations, and agency commentary on Gainful Employment).

<sup>167</sup> See 34 C.F.R. § 668.7(a) (invalidated by *Ass'n of Private Colleges & Univs. v. Duncan*, 870 F. Supp. 2d 133, 137 (D.D.C. 2012)) (vacating that portion of the regulation that required student loan repayment rates to be over 35% on the grounds that the rate was “arbitrary and capricious”).

<sup>168</sup> *Id.* § 668.7(i).

<sup>169</sup> *Ass'n of Private Colleges & Univs. v. Duncan*, 870 F. Supp. 2d 133, 137 (D.D.C. 2012).

<sup>170</sup> *Id.* at 154 (“Because the Department has not provided a reasonable explanation of that figure, the court must conclude that it was chosen arbitrarily.”).

future.<sup>171</sup> While GER was vacated, the separate disclosure provisions were not.<sup>172</sup> Federal officials have refocused the Department's oversight function to promoting transparency instead of substantive quality standards.<sup>173</sup>

The recent push for greater direct regulation of education quality has failed even though GER was a step in the right direction. Federal regulators have had limited success at determining quality of education, either because they cannot react fast enough—the proverbial “whack-a-mole” problem<sup>174</sup>—or because they are restricted by law against direct regulation.<sup>175</sup> Also, these regulations have focused only on for-profit institutions, which are required to show their educations lead to “gainful employment.” This has left non-profit and public institutions largely unregulated for student loan repayment and stricter disclosure standards. The federal government, due to administrative law and its own bureaucratic process, has not been able to implement regulations to provide quality education indicators. Other quality indicators, especially indicators set outside federal regulation, could provide a much better quality of education indicator to students, educators, and regulators.

## 2. Alternative Mechanisms for Educational Quality Control

There have been other proposals to insert indicators based on student loan repayment rates to close the quality education feedback loop. Aside from the failed GER mentioned above, academics have proposed implementing risk-based pricing, put-options for earnings outcomes, and risk sharing through the states. All of these proposals

---

<sup>171</sup> See *Gainful Employment Information*, *supra* note 166.

<sup>172</sup> See, e.g., 34 CFR § 668.6(a); Memorandum from Jeff Baker, Director, Policy Liaison and Implementation, *Federal Student Aid regarding Status of Gainful Employment Regulations* (Jul. 6, 2012), <http://ifap.ed.gov/eannouncements/070612GE39StatusofGainfulEmploymentRegs.html> (last visited Oct. 24, 2013).

<sup>173</sup> See Memorandum from David Bergeron, Acting Assistant Sec'y for Post-Secondary Educ., *Gainful Employment Electronic Announcement #42 – 2011-2012 Disclosures for Gainful Employment Programs* (Nov. 23, 2012), <http://www.ifap.ed.gov/eannouncements/112312GEAnnounce42DisclosureofGEPrograms1112.html> (last visited Oct. 24, 2013).

<sup>174</sup> See generally Fawn Johnson, *'Whack-a-Mole' Continues on For-Profit Colleges*, NATIONAL JOURNAL (June 2, 2012), <http://www.nationaljournal.com/-whack-a-mole-continues-on-for-profit-colleges-20110204>.

<sup>175</sup> See 20 U.S.C. § 1232a (2012) (barring federal control of educational institutions).

help form the policy background to create a market-based indicator to close the educational quality feedback loop.

*a. Risk-Based Pricing*

Professor Michael Simkovic has proposed introducing risk-based pricing on student loans to reduce student loan debt and to provide students with educational outcome indicators.<sup>176</sup> Conceptually, risk-based pricing assigns different interest rates on student loans based on a number of indicators used to predict the borrower's credit risk.<sup>177</sup> Risk-based interest rates could be based on a borrower's choice of major,<sup>178</sup> class rank, test scores,<sup>179</sup> or, to a lesser extent, on the specific characteristics of the institution.<sup>180</sup> For example, a student studying in a STEM major—science, technology, engineering, or math—would have a lower interest rate on his or her loans than a student studying the humanities, journalism, or law.<sup>181</sup> This differential in interest rates would signal to students the riskiness of the debt and also the likelihood of employment and earnings in the field.

The approach described in a 2012 Note published in *Harvard Law Review* differs somewhat in its treatment of risk-based factors by focusing solely on post-graduation employment prospects through two factors: (1) quality of education; and (2) the area of study.<sup>182</sup> The Note proposed using an updated Cohort Default Rate defined by the federal government to determine institutional quality.<sup>183</sup> A Cohort Default rate is defined by statute and regulation and determines the percentage of individuals from the same institution that have defaulted on their student loans.<sup>184</sup> The Note also suggested using two factors to determine the riskiness of a course of study: (1) average wages from a certain major; and (2) debt-to-income ratios.<sup>185</sup>

---

<sup>176</sup> Simkovic, *supra* note 1, at 530; *see also Harvard Note, supra* note 7, at 588–89.

<sup>177</sup> Simkovic, *supra* note 1, at 596–97.

<sup>178</sup> *Id.* at 625.

<sup>179</sup> *Id.* at 630–31 & nn. 282–84.

<sup>180</sup> *Id.* at 622–23.

<sup>181</sup> *Id.* at 625.

<sup>182</sup> *Harvard Note, supra* note 7, at 599.

<sup>183</sup> *Id.* at 599–600.

<sup>184</sup> 20 U.S.C. § 1085(m) (2012); 34 C.F.R. §§ 668.181–668.197, 668.200–668.217 (2012).

<sup>185</sup> *Harvard Note, supra* note 7, at 600.

Risk-based pricing would indicate to student borrowers which areas of study have more repayment risk than others.<sup>186</sup> This approach is laudable because it attempts to close the feedback loop between students, educators, and government officials by guiding educational preferences more efficiently. Also, it presumably will reduce repayment risks to the federal government.

The problem with risk-based pricing is that it introduces risk to signal quality education at precisely the wrong place—the student. It is very unlikely that a prospective student will rationally weigh the varying interest rates for programs to make an informed choice based on a risk-reward analysis. While it is true that college shopping by students and families take up a considerable amount of time already, the addition of risk-based interest rates per program, per school, or both would add another layer of complexity. Thus, different interest rates may not necessarily get the desired result of students making better decisions.<sup>187</sup>

Federally set risk-based pricing may also violate 20 U.S.C. § 1232a, which bars federal control over programs or curriculum, because it would unduly influence an institution's autonomy. Further, if the rates are based on risk and are efficiently priced, then it is unclear why federal funding is required instead of just private loans—unless the risk-based pricing only slightly accounts for the loan risk and there is still a government subsidy.

*b. Institutional Put-Option – Risk-Sharing with Market Based Pricing*

A recent proposal to reform student loans by Michael C. Macchiarola and Arun Abraham encompasses the best public policy incentives while also providing a mechanism to provide educational quality indicators to academic institutions.<sup>188</sup> In their paper, which focuses on law schools exclusively but easily could be expanded to all higher education, they propose that institutions should give students a

---

<sup>186</sup> See *id.* at 598.

<sup>187</sup> See Simkovic, *supra* note 1, at 624 (noting that some relative levels of risk associated with a given student may be based on factors that are beyond that particular student's control and outside the scope of his or her educational decisions).

<sup>188</sup> Macchiarola & Abraham, *supra* note 3, at 119.

put-option to guarantee certain minimum earnings over a period of time.<sup>189</sup>

A put-option is a contract between two parties that gives the buyer—student—“the right, but not the obligation, to sell (to the put seller) an underlying security or other item of value at an agreed-upon price.”<sup>190</sup> Macchiarola and Abraham logically matched expected earnings with what a student would have to earn to repay the student loans within a standard ten year payment schedule if the student paid only fifteen percent of his or her disposable income.<sup>191</sup> This calculation mirrors the IBR payment plan.<sup>192</sup> If the earnings are less than the expected amount, then the student can exercise the put-option to have the school pay the difference between the student’s expected minimum earnings and lower actual earnings.<sup>193</sup>

A put-option bought by universities based on expected earnings of students is both groundbreaking and logically sound.<sup>194</sup> Who better to bear a portion of the risk of a student loan than the institution that provides the service? Because of the informational asymmetry, institutions are better risk-bearers than individual students for adverse outcomes tied to student loans.<sup>195</sup> Also, the put-option is based on individual outcomes, so the institution has a vested interest in encouraging students with high debt levels to choose prudent majors for better career options. The problems with the put-option are as follows: (1) it is too complicated to implement on a student-per-student basis; and (2) institutions, which would bear the cost, do not have an incentive or requirement to implement the program.

*c. Cost Sharing with States: A Roadmap from the 1990s*

The concept of closing the educational feedback loop by financially tying student loan repayment rates to state and institutional performances has been tried before with bipartisan support. In 1991,

---

<sup>189</sup> *Id.* at 120–21.

<sup>190</sup> *Id.* at 119 (citation omitted).

<sup>191</sup> *Id.* at 120.

<sup>192</sup> See generally *Repayment Plans, Financial Student Aid*, U.S. DEP’T OF EDUC., <http://studentaid.ed.gov/repay-loans/understand/plans>, (last visited Apr. 3, 2013).

<sup>193</sup> Macchiarola & Abraham, *supra* note 3, at 121–22.

<sup>194</sup> *Id.* at 97.

<sup>195</sup> *Id.* at 110–11.

George H. W. Bush proposed in his budget a “risk sharing” plan, where states would have to compensate the federal government for poorly-performing student loans from institutions licensed within each state.<sup>196</sup> The proposal became law in 1993 when Congress amended Section 428 of the Higher Education Act by adding subsection (n), titled “Cost Sharing by States.”<sup>197</sup> Somewhat bold at the time, the amendment made states pay a portion of the losses from student loans tied to institutions with a 20% or more cohort default rate.<sup>198</sup> Starting in 1995, the state would be forced to pay 12.5% of the student loan losses from institutions that exceeded the 20% threshold default rate.<sup>199</sup> This rate would then increase to the state paying 50% of any excess over the 20% threshold default rate.<sup>200</sup> The amendment also allowed states to charge fees, subject to the Department’s approval, to institutions based on institutions’ cohort default rates and states’ risk of having to pay the loan losses.<sup>201</sup>

This provided an indirect method of closing the educational feedback loop for poorly-performing schools. If institutions collectively had a default rate higher than 20%, then the state would have been exposed to liability for some of the defaulted student loan losses. States have the power to approve institutions operating in their

---

<sup>196</sup> Mary Crystal Cage, *Bush Proposes That States Share Risks of Student Loans*, THE CHRONICLE OF HIGHER EDUC. (Feb. 13, 1991), <http://chronicle.com/article/Bush-Proposes-That-States/89248/>.

<sup>197</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 4201, 107 Stat. 312, 370–71 (codified as 20 U.S.C. § 1078(n) (1994) (repealed 1998)).

<sup>198</sup> *See id.*; *see also* State Share of Default Costs, 59 Fed. Reg. 52,038, 52,039–40 (Oct. 13, 1994) [hereinafter Cost Sharing Proposed Regs.] (explaining the purpose of the statute and proposed rule in greater detail).

<sup>199</sup> 20 U.S.C. § 1078(n) (1994) (repealed 1998). The calculation finds the amount of loans that exceeded the 20% cohort default rate for all institutions in the state and then applies a fee to the new loan volume based on the amount over 20% from the Cohort Default Rate. A summary of the Calculation: (New Loan Volume For Current Year For All Institutions Within The State) x (Percentage Cost-Share, Starting at 12.5% to 50%) x (Amount of Loans in Default over 20% for Past Repayment Period / All loans From Institutions Within State For The Same Repayment Period). For example, if collectively institutions within the state had 21% of loans in default for the repayment period (21% - 20% is 1% that exceeds the threshold), then the state would have been required to pay the Department in 1995 a fee of 0.125% (1% x 12.5%) on all new loan volume for institutions within that state.

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

state,<sup>202</sup> so the federal law assumed each state would be able to put pressure on poorly performing institutions to improve. The Department attempted to promulgate regulations to clarify the statute but later withdrew the proposed regulations.<sup>203</sup>

This cost sharing scheme was repealed in 1998.<sup>204</sup> It is unclear whether this policy was ever fully implemented or if it had any success.<sup>205</sup> Part of the concern was that the federal government imposed a fee on the states for defaulting loans even though states have little direct authority, outside of institutional approval, to set quality standards.<sup>206</sup>

#### IV. HISTORY OF STUDENT LOAN SECURITIZATION

Any successful student loan reform must provide a feedback mechanism to encourage positive education outcomes while also reducing government risk from student loans. Securitization potentially can fulfill both of these requirements. As to the first requirement, securitization will force third-party pricing of the student loan assets based on expected repayment rates. This will create a market-based price to gauge the quality of education for institutions or programs.

Repayment rates of student loans, as used in the past with GER and the alternative proposals, have not been implemented with the proper incentive structures or feedback mechanisms. A third-party

---

<sup>202</sup> See *State Authorization of Postsecondary Education*, SHEEO, <http://www.sheeo.org/projects/state-authorization-postsecondary-education> (last visited Apr. 5, 2013).

<sup>203</sup> Compare Cost Sharing Proposed Regs., *supra* note 198, at 52,039–40 (proposing to amend 34 C.F.R. § 682.418 to clarify 20 U.S.C. § 1078(n) (1994) (repealed 1998)), with FFEL Final Regulations, 59 Fed. Reg. 61,424, 61,425 (Nov. 30, 1994) [hereinafter Final Cost Sharing Regs.] (“Based on the comments received in response to the NPRM, the Secretary has determined that more time is needed to review and address the concerns raised by the commenters regarding implementation of section 428(n) of the HEA.”).

<sup>204</sup> Higher Education Amendments of 1998, Pub. L. No. 105-244, § 417(j), 112 Stat. 1581, 1690.

<sup>205</sup> Missouri, for example, enacted a law in 1994 to evaluate its financial risk from the new cost sharing program established by the then-current, now repealed, version of 20 U.S.C. § 1078(n). See MO. REV. STAT. § 173.055 (1994) (repealed 2012).

<sup>206</sup> See Final Cost Sharing Regs., *supra* note 203, at 61,425; Cage, *supra* note 196.

pricing mechanism, where institutions retain some of the risk of student loans, provides incentives to institutions to change their behavior to achieve better educational outcomes and repayment rates. The government already has demonstrated a willingness to use third-party pricing mechanisms to set student loan interest rates.<sup>207</sup> While certainly imperfect, this type of quality education indicator provides direct feedback to students, regulators, and officials and bypasses concerns about the federal government directly regulating the quality of education.

As to the second requirement, the federal government, through securitization, could reduce its exposure to risk by selling all or a portion of its \$1 trillion direct loan portfolio to private investors. From a budgetary standpoint, there are two reasons for selling student loans to third parties. First, by selling the loans, the risk exposure to the federal government is reduced proportionally. As demonstrated in the discussion of FCRA estimates, the federal government has struggled to accurately monitor or price loan risks. Selling some of these assets would reduce the impact of this risk. Second, by selling the loans, the federal government is capitalizing assets that can be used either to make more loans, fund other federal programs, or to pay off debt.

Here, the benefits become even more apparent: if the Department sells \$500 billion in student loans, it could reduce the federal debt—issued to pay out the loans in the first place—and increase its available revenue. This one-time benefit could be used strategically at a time of fiscal crisis to raise money, much like a corporation sells assets to recapitalize its balance sheet.<sup>208</sup> Currently, there is a robust market for third-party investment in student loans and the federal government could capitalize on this demand while reducing risk.<sup>209</sup> The following

---

<sup>207</sup> Bipartisan Student Loan Certainty Act of 2013, Pub. L. No. 113-28, 127 Stat. 506, §2(a); 20 U.S.C. § 1087e(b) (2012).

<sup>208</sup> Of course, there have to be buyers and a fire-sale of the assets is even less beneficial. One could easily imagine a situation where the federal government is attempting to sell off assets during a crisis (e.g., during the sub-prime crisis of 2008) to raise funds and the market is incapable of purchasing the assets at a market rate. Alternatively, the federal government has had modestly positive results selling the assets in the TARP program. *See Report of the Troubled Asset Relief Program*, CONG. BUDGET OFFICE (Oct. 11, 2012), [http://www.cbo.gov/sites/default/files/cbofiles/attachments/TARP10-2012\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/TARP10-2012_0.pdf).

<sup>209</sup> *See* SOCIAL FINANCE, *infra* note 249; COMMONBOND, *infra* note 252 (numerous for-profit and non-profit companies have recently sprung up to refinance federal student loans).



sections analyze whether securitization of federal direct loans has been attempted in the past and whether such an approach would be feasible in terms of public policy and the federal budget.

### A. Securitization Principles

Securitization is a vague term that courts, federal officials, and scholars have struggled to define. This lack of definition makes it hard for parties to understand their contractual obligations, rights, and risks. Notably, the term “securitization” has not even been defined by the most recent reform to financial regulations, Dodd-Frank.<sup>210</sup> In broad terms, securitization is the pooling of payable accounts—accounts receivable, mortgages, credit card receivables, student loans—into one legal entity to hold the assets, which are collectively sold to third parties as one diversified investment. Simplified, the structure of securitization looks like this:

#### Inputs → Structure → Outputs

Jonathon Lipson recently defined securitization more narrowly by distinguishing true securitization in a legal sense from other similar capital structures. In his article, *RE: Defining Securitization*, he provides this overarching definition:

[T]rue securitization is defined as a purchase of primary payment rights by a special purpose entity that (1) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (2) results, directly or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased.<sup>211</sup>

This definition focuses on isolation at bankruptcy through a “true sale” because there is a legal transaction that clearly defines ownership, rights, and obligations.<sup>212</sup>

In summary, Lipson’s definition requires inputs (loans/receivables), a structure (Special Purpose Entity (SPE) that is legally separated from the parent corporation), and outputs (selling of

<sup>210</sup> Lipson, *supra* note 6, at 1258 (“Dodd-Frank—the most ambitious attempt to regulate capital markets since the Depression . . . does not even attempt to define securitization.”); *see also* Dodd Frank Wall Street Reform and Consumer Protections Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

<sup>211</sup> *Id.* at 1233.

<sup>212</sup> 11 U.S.C. § 362(a) (2012).

securities backed by inputs).<sup>213</sup> For example, if a bank sells a mortgage to a SPE, the sale must be a true sale in the eyes of the bankruptcy court so that if the SPE becomes bankrupt, there are no residual rights against the bank.<sup>214</sup> A SPE, usually separately incorporated to segregate liability and obligations from the owner of loans, raises money by selling ownership of itself to pay the originator of the loans.

A prominent legal scholar, Steven Schwarcz, rejected this formalistic framework in favor of a more flexible definition.<sup>215</sup> Schwarcz argues that securitization should: (1) be pragmatic; (2) mirror market perception of the term; and (3) be flexible enough to evolve with financial evolution.<sup>216</sup> According to Schwarcz, the Lipson definition restricts certain structured finance models that traditionally have been labeled as securitization.<sup>217</sup> Under the Lipson definition, a collateralized debt obligation (CDO) would not be an example of securitization because such an obligation does not result in a true sale.<sup>218</sup> CDOs are securities sold in the market like bonds; a CDO's interest payments are derived from rights to pools of receivables, such as mortgages or student loans, but there is no direct ownership.<sup>219</sup> While the Lipson definition is more precise, the Schwarcz concept arguably is the more generally accepted definition of securitization.

### **B. Government Sponsored Enterprises & Securitization**

The federal government is no stranger to securitizing its loans programs. From a formalistic perspective, a GSE represents one of the first and largest incarnations of SPEs used in securitization. While many claim that Lewis S. Ranieri and other bond traders at Solomon Brothers were the “Fathers of Securitization,”<sup>220</sup> the concept was pioneered in the 1930s during the Great Depression through the creation of GSEs to help fund residential mortgages and increase

---

<sup>213</sup> Lipson, *supra* note 6, at 1233.

<sup>214</sup> *See id.* at 1233–34.

<sup>215</sup> Schwarcz, *supra* note 6, at 1284.

<sup>216</sup> *Id.* at 1288–95.

<sup>217</sup> *Id.* at 1284.

<sup>218</sup> *See id.* at 1293.

<sup>219</sup> *Id.* at 1292–93.

<sup>220</sup> Lewis S. Ranieri: *Your Mortgage Was His Bond*, BUSINESS WEEK (Nov. 28, 2004), <http://www.businessweek.com/stories/2004-11-28/lewis-s-dot-ranieri-your-mortgage-was-his-bond>.

access to homeownership.<sup>221</sup> Ginnie Mae further developed the Mortgage Backed Security (MBS) market in 1970.<sup>222</sup> A GSE is defined loosely but has the following general characteristics: “(1) private sector ownership, (2) limited competition, (3) activities limited by congressional charter, and (4) chartered privileges that create an inferred federal guarantee of obligations.”<sup>223</sup> GSEs traditionally were created to provide liquidity in loan markets, which theoretically increases the money available to lend to individuals—be they students, potential home owners, or farmers.<sup>224</sup>

By creating a “market” for these loans, lenders are able to sell them to investors—thus capitalizing the assets—and then relend the money to new lenders. In macro-economics, this process commonly is referred to as the money multiplier theory and is used to explain how the government can increase or decrease money supply.<sup>225</sup> Where GSEs were instituted to provide liquidity, theoretically there should be an increase in lending and money supply in a particular lending market.

Using the logic of liquidity and improved access to money, Congress formed the GSE Sallie Mae in 1972 to buy guaranteed student loans from lenders to recapitalize private lenders.<sup>226</sup>

---

<sup>221</sup> See, e.g., Andrea J. Boyack, *Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac*, 60 AM. U. L. REV. 1489, 1495 (2011).

<sup>222</sup> Alan Feuer, *Poof! How Home Loans Transform*, N.Y. TIMES (Sept. 18, 2009), <http://www.nytimes.com/2009/09/20/nyregion/20mortgage.html>.

<sup>223</sup> Kevin R. Kosar, *Government Sponsored Enterprises (GSEs): An Institutional Review*, CONG. RESEARCH SERVICE CSR-2 (Apr. 23, 2007), <http://www.fas.org/sgp/crs/misc/RS21663.pdf>.

<sup>224</sup> *Id.* at CSR-3.

<sup>225</sup> See, e.g., Seth B. Carpenter & Selva Demiralp, *Money, Reserves, and the Transmission of Monetary Policy: Does the Money Multiplier Exist?*, U.S. DEP’T OF TREASURY 3 (May 2010), <http://www.federalreserve.gov/pubs/feds/2010/201041/201041pap.pdf>; Bill Mitchell, *Money Multiplier and Other Myths*, BILL MITCHELL BILLY BLOG (Apr. 21, 2009), <http://bilbo.economicoutlook.net/blog/?p=1623>. Other scholars have disagreed with the macro-economic impact of this policy. See, e.g., Carpenter & Demiralp, *supra*, at 2.

<sup>226</sup> Education Amendments of 1972 § 439(b)(1), Pub. L. No. 92-318, 86 Stat. 265 (1972).

The Congress hereby declares that it is the purpose of this section to establish a Government-sponsored enterprise which will be financed by private capital and which will serve as a secondary

Eventually, Sallie Mae would buy the loans, package them together, and sell securities based on these assets—commonly referred to as Student Loan Asset-Backed Securities (SLABS), which are structurally similar to MBS. GSEs also have favorable accounting treatment for the federal budget because the balance sheets of GSEs, such as Fannie Mae, Freddie Mac, and Sallie Mae—now completely privatized—are not included in the federal balance sheet.<sup>227</sup>

During the 2008 economic crisis, however, the government was forced to purchase loan assets from Fannie Mae and Freddie Mac and report these credit risks as a liability on the balance sheet.<sup>228</sup> This is an example of how GSE risk, while off the balance sheet, can still impact the federal government. Ginnie Mae, which is backed fully by the federal government, is also considered a GSE in order for the federal government to remove the loans and guarantees from the federal balance sheet.<sup>229</sup> The impact of this accounting treatment for GSEs is that the government provides only a guarantee on the loans, or some portion thereof, similar to the FFEL program, and most of the costs and loan assets are not shown on the federal balance sheet.

### C. Dodd-Frank “Skin in the Game” Risk Retention Provisions

Securitizing companies such as GSEs and banks created a negative feedback loop where originators did not have an incentive to ensure quality lending requirements.<sup>230</sup> This is conceptually similar to the lack of institutional incentives to improve repayment rates of student loans. In the housing market, banks or lenders would originate loans and then sell the loan immediately to a third party through securitization. Because originators had a financial incentive to close the loan and to sell it at par value, underwriting standards became lax.<sup>231</sup> Regulators

---

market and warehousing facility for insured student loans, insured by the Commissioner under this part or by a State or nonprofit private institution or organization with which the Commissioner has an agreement under section 428(b), and which will provide liquidity for student loan investments.

*Id.*; see Wolfe, *supra* note 47.

<sup>227</sup> 2012 U.S. FINANCIAL REPORT, *supra* note 114, at 85.

<sup>228</sup> *Id.* at 11.

<sup>229</sup> *Ginnie Mae & the GSEs*, GINNIE MAE, [http://www.ginniemae.gov/consumer\\_education/Pages/ginnie\\_mae\\_and\\_the\\_gses.aspx](http://www.ginniemae.gov/consumer_education/Pages/ginnie_mae_and_the_gses.aspx) (last visited Dec. 12, 2013).

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

have explained this concept by stating that originators did not have any proverbial “skin in the game.”<sup>232</sup> This negative feedback loop and other issues in the lending industry forced Congress to pass a risk retention provision in the Dodd-Frank Act.<sup>233</sup>

The Dodd-Frank Act requires that any securitizer of an asset-backed security retain not less than five percent ownership of any security it issues.<sup>234</sup> A securitizer is an entity that issues asset-backed securities or organizes and initiates such sales.<sup>235</sup> An asset-backed security is a fixed income asset, or collateralized financial asset, that pays the holder primarily through payments from the loans it owns.<sup>236</sup> This risk retention requirement includes SLABS of private student loans and also may include SLABS of FFEL loans.<sup>237</sup> This requirement has been contentious, with many scholars arguing that it limits the marketplace, impedes the purpose of securitization—selling assets, reducing risk, liquidity—and is ineffective at achieving its goal of aligning incentives between originators, securitizers, and investors.<sup>238</sup>

Currently, academic institutions are not originators under Dodd-Frank because they do not issue student loans or securities based on student loans. However, it would not be too great a conceptual leap to redefine academic institutions as originators under Dodd-Frank and subject them to the risk retention provisions.

The retention requirement also pulls the definition of securitization into the forefront to determine whether student loans could be sold to private investors. The retention requirement creates a residual obligation or ownership, which could be interpreted to block the “true sale” requirement imposed by Lipson’s definition.<sup>239</sup> This definition, if applied to student loan securitization, would make it difficult to retain

---

<sup>232</sup> David Line Batty, *Dodd-Frank’s Requirement of “Skin in the Game” for Asset-Backed Securities May Scalp Corporate Loan Liquidity*, 15 N.C. BANKING INST. 13, 44 (2011); Toben & Osolinik, *supra* note 46, at 196.

<sup>233</sup> 15 U.S.C. § 78o-11 (2012).

<sup>234</sup> *Id.* at § 78o-11(c)(1)(B).

<sup>235</sup> *Id.* at § 78o-11(a)(3).

<sup>236</sup> *Id.* at § 78c(79)(A).

<sup>237</sup> Toben & Osolinik, *supra* note 46, at 196.

<sup>238</sup> *Id.*; Batty, *supra* note 232, at 38 (arguing that it is unlikely that the risk retention requirements would have reduced the risk associated with the subprime mortgage crisis).

<sup>239</sup> See Lipson, *supra* note 6, at 1233.

the Income-Base Repayment and Public Service Loan Forgiveness programs without the government having a residual obligation to the investor to cover the cost of the programs.

#### **D. Securitization of Student Loans**

A comparison of the markets for student loans and mortgages leads to an interesting policy analysis because the government has adopted markedly different approaches for solving problems related to liquidity, risk reduction, and credit enhancements. Other scholars also have drawn close similarities to the sub-prime mortgage market and the current student loan market.<sup>240</sup> Prior to 2010, the government used Sallie Mae and other entities to securitize the FFEL guaranteed loans. Since then, however, the government has opted to lend directly to students and place the loans on its balance sheet using FCRA to estimate its value. By comparison, the government relies almost exclusively on GSEs and private banks to provide liquidity in the residential mortgage market.<sup>241</sup>

So, why would the government securitize the assets of mortgages but not student loans? Generally, there are two issues. First, a mortgage is backed by a secured interest in real property, while a student loan has no secured interest. Second, a robust private mortgage market exists with minimal direct government involvement, whereas most student loans are funded directly through the government; thus, there is less need to securitize student loans.<sup>242</sup> Despite these limitations, the framework for securitizing student loans is already in place from previous FFEL programs, and it would not be difficult to implement. The Department has statutory authority to sell loans to third parties so long as it is “in the best interest of the United States.”<sup>243</sup> It also has methods for measuring actual and estimated cash flows based on loan cohorts’ classes, schools, or programs.<sup>244</sup>

---

<sup>240</sup> See Wimberg, *supra* note 5, at 190–91.

<sup>241</sup> 2012 U.S. FINANCIAL REPORT, *supra* note 114, at 68.

<sup>242</sup> There is, however, a rebuttal that the nationalization of Fannie Mae and Freddie Mac are clear examples of direct involvement and support from the government to aid the securitization of mortgages.

<sup>243</sup> 20 U.S.C. § 1087i (2012).

<sup>244</sup> See FSA 2012 BUDGET, *supra* note 41, at 103–07 (auditor’s discussion of the Department’s methods for calculating estimated cash flows based on current historical results).

### E. Current Market for Securitized Student Loans

If securitization is to be used as a public policy tool to reform the student loan market, there must first be some proof that an established market exists for such investments. Private student loans, which are arguably more risky than federal loans, have been securitized into SLABS, and there has been an active market for these securities for years.<sup>245</sup> The FFEL loans also were securitized through lenders such as Sallie Mae, and some of these loans still exist on government's balance sheet even though the program was defunded in 2010. Directly owned federal loans also have been the target of investors who are eager to capitalize on the relatively high interest rates.<sup>246</sup>

Some companies have recently sprung up to refinance federal student loans by seeking investors from social and economic standpoints. Social Finance (SoFi), for example, raises money from alumni to either refinance student loans from federal loans or directly originate new loans.<sup>247</sup> The alumni are able to invest in students from their alma mater while also receiving a small return on investment.<sup>248</sup> The company focuses on refinancing or loaning to students that have higher interest federal loans—6.8% to 7.9%—by offering loans at 5.99%, with lower fees, and matching the repayment terms of the Direct Loan Program.<sup>249</sup> By November 2012, the company originated over \$90 million in loans and had to pause its lending because demand exceeded funding from alumni investors.<sup>250</sup> It even obtained \$60 million of funding from Morgan Stanley to originate more loans.<sup>251</sup>

---

<sup>245</sup> *Private Student Loans*, CONSUMER FINANCIAL PROTECTION BUREAU (Aug. 2012), [http://files.consumerfinance.gov/f/201207\\_cfpb\\_Reports\\_Private-Student-Loans.pdf](http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf).

<sup>246</sup> Jason Delisle, *Wall Street's Pitch to Profit on Federal Student Loans*, NEW AMERICA FOUNDATION (Oct. 12, 2011), <http://higheredwatch.newamerica.net/node/58962>.

<sup>247</sup> Christina Farr, *SoFi's CEO: 'The Student Loan Market is Broken. Let's fix it'*, VENTURE BEAT (Sept. 18, 2012), <http://venturebeat.com/2012/09/18/sofi-student-loan/>.

<sup>248</sup> *Id.*

<sup>249</sup> *See Frequently Asked Questions*, SOCIAL FINANCE, <https://www.sofi.com/faq.php> (last visited May 15, 2013).

<sup>250</sup> *SoFi Begins Lending Again to Students and Graduates of 78 Schools*, SOCIAL FINANCE (Apr. 2, 2013), <https://www.sofi.com/press/sofi-begins-lending-again-to-students-and-graduates-of-78-schools/>.

<sup>251</sup> *Id.*

Companies like SoFi and the existing SLABS market represent a proof-of-concept for whether there is a market for securitizing federal student loans.<sup>252</sup>

Securitization also would reduce the Department's administrative burden of directly managing its \$1 trillion loan portfolio, which it has struggled to manage appropriately in the past. Just recently, the Department could not identify and assume control of over \$1.1 billion of delinquent loans managed by loan servicers.<sup>253</sup> This delayed debt collection activities on the defaulted loans and also prevented individuals from rehabilitating the delinquent debt to regular status.<sup>254</sup>

Securitization is only feasible if the FCRA is reformed to encompass fair-value accounting concepts. Otherwise, securitizing student loans would result in large losses from selling the loans at market rates—as opposed to the inflated FCRA estimates currently on the federal balance sheet.<sup>255</sup> By itself, the combined benefit of reducing risk exposure and capitalizing assets is not likely to be persuasive enough to change federal student loan policy. It does, however, provide a structural mechanism to introduce market-based risk pricing into postsecondary education. This feedback from neutral, third-party investors can provide another quality education indicator to participants.

## V. PROPOSALS TO REDUCE GOVERNMENT RISK

Proposals for reducing government risks can be divided into two categories. The first category includes proposals that can be implemented immediately: (1) reforming the FCRA to more accurately show the riskiness of student loan debt; (2) securitizing federal student loan assets to reduce government risk; and (3) creating a market-based risk sharing mechanism to offset some or all losses from securitization

---

<sup>252</sup> See *Info Center*, COMMONBOND, <http://commonbond.co/student-borrowers> (last visited May 15, 2013).

<sup>253</sup> *Debt Management Collection System*, DEP'T OF EDUC. OFFICE OF INSPECTOR GENERAL 2 (Dec. 13, 2012), <http://www2.ed.gov/about/offices/list/oig/audit/reports/fy2013/102m0008.pdf>.

<sup>254</sup> *Id.*

<sup>255</sup> Jason Delisle, *Fair-Value Accounting Shows Switch to Guaranteed Student Loans Costs \$102 Billion*, NEW AMERICA FOUNDATION (Mar. 23, 2013), [http://edmoney.newamerica.net/blogposts/2012/fair\\_value\\_accounting\\_says\\_switch\\_back\\_to\\_guaranteed\\_student\\_loans\\_costs\\_102\\_billion-](http://edmoney.newamerica.net/blogposts/2012/fair_value_accounting_says_switch_back_to_guaranteed_student_loans_costs_102_billion-).



and provide a quality education indicator. The second category includes proposals that will require further study: (1) devising programs for risk-sharing mechanisms for loan assets; (2) devising securitization structures by institutional origination through Perkins Loans and pooling of federal assets with cost sharing provisions; and (3) devising pooling options for securitization.

#### **A. Proposals that Can Be Implemented Immediately**

##### **1. Fair-Value Accounting & FCRA Reform**

The federal government's accounting of student loans is flawed and should be changed to reflect fair-value accounting principles, which would take into account contingent losses that are known and reasonably estimated and the gains or losses caused solely by adjustment of federal interest rates.<sup>256</sup> The recent change tying new loans to 10-Year Treasury Notes does not fully mitigate FCRA cost estimate losses because of caps on the rates,<sup>257</sup> and it does not address the inaccurate estimates of existing loans. A change to fair-value accounting will cost the government by limiting the existing 'negative subsidy' of federal loans and by more accurately writing down losses based on the income-based repayment and public service loan forgiveness programs,<sup>258</sup> however, this accounting reform likely will be required regardless of whether federal officials attempt additional student loan reforms. Currently, the government receives roughly \$35 billion in negative subsidies annually,<sup>259</sup> and this undoubtedly will be reduced when the government begins to estimate the value of the loans more accurately.

If the Department is forced to account more accurately for its student loan assets, losses from securitization will be reduced. In its current form, any securitization will result in automatic losses to the federal government because the loan assets are inflated artificially through FCRA accounting. Without full guarantees of principal and interest payments similar to the FFEL program, private investors will demand lower prices for the assets than the valuation carried on the Department's balance sheet because of known risk exposure

---

<sup>256</sup> See *id.*; FAIR-VALUE ACCOUNTING, *supra* note 141, at 1.

<sup>257</sup> See Bipartisan Student Loan Certainty Act of 2013, Pub. L. No. 113-28, 127 Stat. 506, § 2; 20 U.S.C. § 1087e(b) (2012).

<sup>258</sup> See Delisle, *supra* note 255.

<sup>259</sup> See *supra* notes 125–129 and accompanying text.

unrecognized through the current FCRA calculation. Thus, before any sort of substantial student loan reform can occur, such as securitization or risk sharing, a change to fair-value accounting is needed.

## 2. Securitization of Loans to Reduce Risk

Assuming accounting reform is successful, the federal government should securitize some of its student loan assets by selling them to third-party investors in order to reduce its future risk exposure—even if it is fairly valued at the time of sale. There are a number of methods the Department or the Treasury could take to monetize these assets. These structures depend on the different definitions of securitization, as discussed in Part IV. Generally, the federal government could securitize its student loan assets in the following ways: (1) transfer assets to a GSE similar to Ginnie Mae and issue SLABS with some form of federal guarantees for principal and interest; (2) directly issue SLABS just like Sallie Mae does for private loans; or (3) sell a collateralized debt obligation with risk exposure to the student loan assets but with no direct ownership.

The creation of a special purpose entity in the form of a GSE is a proven approach to minimizing federal risk exposure to loan assets but would not provide any reform in higher education. Because the federal government fully owns all direct loans, it has the power to sell them to a GSE.<sup>260</sup> Sallie Mae did this until it became privatized in the late 1990s.<sup>261</sup> Structurally, this would be similar to Fannie Mae or Freddie Mac, whereby the GSE provides guarantees for some principal and interest. It would not have the explicit backing of the federal government unless it was structured similar to Ginnie Mae, which has explicit government guarantees.<sup>262</sup> The funding mechanism effectively would deleverage the federal government, but it would not introduce risk-pricing into the higher education market.<sup>263</sup>

---

<sup>260</sup> 20 U.S.C. § 1087i.

<sup>261</sup> See Student Loan Marketing Association Reorganization Act of 1996, Pub. L. No. 104-208, tit. VI, 110 Stat. 3009-275.

<sup>262</sup> See Kathleen Pender, *How Ginnie Mae differs from Fannie, Freddie*, SAN FRANCISCO CHRONICLE (Aug. 5, 2008), <http://www.sfgate.com/business/article/How-Ginnie-Mae-differs-from-Fannie-Freddie-3201149.php>.

<sup>263</sup> A GSE structure, with subsidies for principal and interest similar to Ginnie Mae, does not introduce risk-pricing because there is no differentiation of risk between loans; they are all equally supported or guaranteed by the government. Such a structure reduces risk by selling assets but it does not adequately signal

A similar proposal was made by investment bankers in 2011, although it did not use a GSE structure.<sup>264</sup> Under this proposal, the government would have issued \$555 billion in federal debt that would have been bought by private investors to refinance federal direct loan assets. The student loans would have been removed from the balance sheet and reclassified as some other form of debt.<sup>265</sup> As a result, the newly issued debt would have been 100% guaranteed by the federal government.<sup>266</sup> While this would not reduce the government's risk exposure, it would allow investment bankers to generate large fees for underwriting the new securities.<sup>267</sup>

From a public policy perspective, it is imperative that the federal government retain some level of control over repayment programs. In the case of a true sale of the loan assets, the government would have to: (1) issue some sort of guarantee to cover the risk of public loan forgiveness, and (2) subsidize loans that have income-based repayment plans. These repayment programs reflect Congress' recognition that providing a better safety net and payment flexibility is sound social policy.<sup>268</sup> However, under a securitization scheme, these programs increase the complexity of the structured finance products, which already are complicated by repayment risk and other factors.<sup>269</sup>

Some form of a CDO likely provides the most flexible method of securitizing student loans assets. Structurally, the Department would issue SLABS bonds that would be tied to student loan revenue streams. The holders of these bonds would not directly own the loan assets; instead the bondholders would own the rights to all or some of the revenue streams as payments are made by students. Thus, by retaining ownership of the loans, the Department would be able to continue its assistance programs to students while at the same time reducing risk exposure from the asset sales. If a person qualifies for

---

which loans are riskier than others. Additionally, the federal government would still bear the majority of the risk for the loans through the guarantees.

<sup>264</sup> Delisle, *supra* note 246.

<sup>265</sup> 2012 U.S. FINANCIAL REPORT, *supra* note 114, at 11.

<sup>266</sup> *Id.*

<sup>267</sup> *Id.*

<sup>268</sup> Glater, *supra* note 104, 58–59.

<sup>269</sup> *Costs and Policy Options for Federal Student Loan Programs*, CONG. BUDGET OFFICE 21 (Mar. 2010), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/110xx/doc11043/03-25-studentloans.pdf>.

debt forgiveness or cancellation, this would operate similar to an early repayment event, which would be funded by the Department from that year's budget.<sup>270</sup> Additionally, using this CDO approach, the government could either sell the assets as one risk profile—every investor receives the same risk and portion of payment—or through tranches—investors choose their priority to receive payments in return for higher or lower yields on the amount invested.<sup>271</sup> The debt obligation could be managed by the Department, the Federal Treasury, or a Special Purpose Vehicle within the government.<sup>272</sup> Through the FFEL program and the emergency ECASLA program, the Department has an expertise in handling similarly complex loan transactions.<sup>273</sup> Additionally, the Department supervises loan servicers for all direct loans.<sup>274</sup> The federal government has the expertise to securitize these assets, especially if incentives are given to investment bankers to assist the process through underwriting fees.<sup>275</sup>

Securitization, as a way to reduce risk to the government, arguably does not form a strong enough reason for restructuring federal student loan programs. Due to market risks, like those that lead to the 2008 crisis, securitization may not actually reduce risk exposure. Also, in order to entice private investors, the government must sell the assets at or below market value.<sup>276</sup> Without FCRA reform, this undoubtedly will be lower than the current value on the Department's balance sheet.<sup>277</sup> What securitization does accomplish, however, is to open student loan assets to financial evaluation by third parties. If there is

---

<sup>270</sup> This also has the added benefit of forcing a clearly defined recognition event on the Department for better loss estimates on student loan assets.

<sup>271</sup> Andreas Jobst, *Back to Basics: What is Securitization?*, FINANCE & DEVELOPMENT - INTER. MONETARY FUND 49 (Sept. 2008), <http://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf>.

<sup>272</sup> See 2012 U.S. FINANCIAL REPORT, *supra* note 114, at 11 (Federal investments in TARP); *ECASLA Programs*, *supra* note 72, at 2.

<sup>273</sup> *ECASLA Programs*, *supra* note 72, at 2.

<sup>274</sup> Marian Wang, *Student Loan Borrowers Dazed and Confused by Servicer Shuffle*, PROPUBLICA (Apr. 23, 2012), <http://www.propublica.org/article/student-loan-borrowers-dazed-and-confused-by-servicer-shuffle>.

<sup>275</sup> *Contra* Delisle, *supra* note 246 (asserting that high fees without risk retention may hurt the investment as well).

<sup>276</sup> This is just an economic concept; no private investor will purchase something above market value.

<sup>277</sup> See FAIR-VALUE ACCOUNTING, *supra* note 141; Delisle, *supra* note 255.

market exposure to the loan assets, and not just 100% guarantees on the securitized debt, then investors will assign market-based prices based on the repayment risk. This risk pricing mechanism creates a great opportunity to form another quality education indicator for higher education institutions.

### 3. Market-Based Risk Sharing Mechanisms as Quality Education Indicators

If the first two proposals are feasible, there is an opportunity to combine the concept of Cost Sharing with States from the 1990s with the general premise of the Put-Option proposal to create a market-based quality education indicator.<sup>278</sup> Instead of the states bearing the burden for defaulting loans, this proposal would force academic institutions to retain at least some of the credit risk of their students' loans through risk retention. Once the loans are securitized, the institutions would bear some portion of the risk. This would force schools to incorporate such risks into their cost-benefit analyses. If a school cannot bear the cost or risk, then the school will reduce risky programs or shutdown.

Successful institutions will either internalize the additional costs, if any, or pass the increased cost onto students with higher tuition. This, much like the Risk-Based Pricing proposal by Simkovic,<sup>279</sup> would provide a quality education indicator to students for certain programs or institutions without directly regulating loan interest rates. Institutions would have the flexibility to determine whether to pass the cost onto students. For example, a for-profit institution may choose to bear the cost of government securitization to keep tuition low for better long-term repayment rates. A large public university may choose just to pass the cost onto the students.

This incentive structure could provide quality education indicators to help institutions close the feedback loop on whether an education program provides sufficient outcomes. Institutions could make programs with risky learning outcomes—architecture, arts, English, law—more selective to allow only the best students to enroll. This would limit an institution's exposure to defaulting student loans and would presumably create better student outcomes. Additionally,

---

<sup>278</sup> See 20 U.S.C. § 1078(n) (1994) (repealed 1998); Macchiarola & Abraham, *supra* note 3, at 119–125.

<sup>279</sup> See Simkovic, *supra* note 1, at 530.

institutions would be forced to make explicit cost-benefit analyses as to whether a program provides sufficient employment outcomes to justify the risk exposure of the student debt. It is possible that the increased cost from risk sharing could be folded into future tuition increases.<sup>280</sup> Thus, future students would pay a higher cost of education because of bad outcomes of past students. This increased tuition cost could dissuade prospective students from attending the institution in favor of cheaper options where the risk sharing costs of loan repayments are decreased.

Implementation of this proposal would also force institutions to take a more proactive role in providing academic advising and career counseling. By giving accurate and realistic advice on choosing a major and a career, a school would be able to reduce its risk by promoting career paths that tend to be successful. Some institutions have started to apply this concept. The approach, however, has been piecemeal, and the incentive structure is lacking.<sup>281</sup> The Consumer Financial Protection Bureau already has a program called “Know Before You Owe,” but it is not integrated with financial aid or academic advising at institutions.<sup>282</sup>

Most importantly, through implementation of this proposal, accrediting agencies will receive direct feedback from the market as to whether institutions provide educations of sufficient quality. For example, if one offering of securitized student loans imposes a larger cost than that of similar offerings, the accreditors will receive a clear indication that there is something potentially wrong with the quality of education at the institution offering the loans. The high cost of such an offering also would indicate to the federal government that there is a

---

<sup>280</sup> See Dylan Matthews, *How Georgetown Law Gets Uncle Sam To Pay Its Students' Bills*, THE WASHINGTON POST (Aug. 9, 2013), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/08/09/how-georgetown-law-gets-uncle-sam-to-pay-its-students-bills/> (arguing Georgetown Law Center just passes increased costs into future higher tuition).

<sup>281</sup> See Thomas L. Harnisch, *Boosting Financial Literacy in America: A Role for State Colleges and Universities, Perspectives*, AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES 2 (Fall 2010), [http://www.aascu.org/uploadedFiles/AASCU/Content/Root/PolicyAndAdvocacy/PolicyPublications/AASCU\\_Perspectives\\_Boosting\\_Financial\\_Literacy\(3\).pdf](http://www.aascu.org/uploadedFiles/AASCU/Content/Root/PolicyAndAdvocacy/PolicyPublications/AASCU_Perspectives_Boosting_Financial_Literacy(3).pdf) (advocating for financial planning programs and services by institutions).

<sup>282</sup> *Know Before You Owe*, CONSUMER FINANCIAL PROTECTION BUREAU, <http://www.consumerfinance.gov/students/knowbeforeyouowe/about/> (last visited May 15, 2013).

need to encourage accrediting agencies to review the policies of the aforementioned institutions; this market-based indicator would compensate for the statutory prohibition against the government itself making judgments about the quality of education.<sup>283</sup> Conceptually, this is similar to bond and credit ratings for universities that are monitored by accreditors.<sup>284</sup>

Additionally, institutions must prove their administrative capacity and financial responsibility, of which credit ratings and audits are a component, to be eligible to receive Title IV funds.<sup>285</sup> Instead of placing the risk on the student by using risk-based pricing as proposed by Simkovic,<sup>286</sup> this proposal does not penalize young students that have asymmetrical information in the postsecondary education market.

### **B. Proposals that Require Further Study**

This section will outline the different policy options for risk retention, securitization structures, and pooling methods. Combinations of these structures will require further study by economists, politicians, and regulators to determine which would be the easiest to implement. While any of these methods are feasible, it would be premature to eliminate one method over the other without additional research. Because they only outline the process for securitization, these securitization mechanics do not detrimentally impact the underlying policy goals of reducing government risk and providing a quality educational feedback indicator to institutions.

#### **1. Risk-Sharing Losses & Risk Retention of Loan Assets**

There are two potential methods to create a risk retention mechanism with securitized student loans. First, the federal government could utilize a risk-sharing device similar to previously proposed and repealed cost sharing structures for defaulting loans

---

<sup>283</sup> See generally 20 U.S.C. § 1232a (2012).

<sup>284</sup> See, e.g., *Resource Manual For The Principles of Accreditation: Foundation For Quality Enhancement*, SOUTHERN ASSOCIATION OF COLLEGES AND SCHOOLS 28–29 (2012), <http://www.sacscoc.org/pdf/Resource%20Manual.pdf>. Core Component 2.11 requires a sound financial base and financial stability. *Id.* Examples of documentation: “Rating agency reviews with special attention to any upgrades or downgrades in bond Ratings.” *Id.*

<sup>285</sup> 34 CFR § 668.14(b)(4) (2012). See generally 34 CFR §§ 668.15, 668.16.

<sup>286</sup> See Simkovic, *supra* note 1, at 530.

enacted in the 1990s.<sup>287</sup> When the securities are sold on the open market, institutions would be fully or partially responsible for covering any losses to the federal government. For instance, if the security was at a \$1000 par value, riskier student loans would sell at \$950 to increase the yield to compensate for the risk. This would result in a loss of \$50 to the federal government. Based on each school's proportional representation of the student loans in the security, each school would be forced to contribute funds to compensate the federal government for this loss. Like the previous risk sharing proposal in the 1990s, the institutions could be forced to cover only a portion of the loss.<sup>288</sup> There also could be mitigating factors such as local unemployment rates, an institution's status as a historically black college, or income levels for the local area.<sup>289</sup>

Second, the federal government could interpret institutions as being "originators" of the asset-backed-securities created from the securitized student loans to trigger the risk retention requirements of Dodd-Frank. Dodd-Frank requires originators of securitized assets to retain a five percent ownership of those assets.<sup>290</sup> For example, for a \$1,000 security, comprised of ten \$100 loans from one institution, the institution would be forced to own exposure to \$50 of debt. As an owner of the asset, the institution would receive a portion of loan repayments like any other investor. Alternatively, it could either buy the ownership from the Department at par value, \$50, or buy an option from a third party to cover the five percent interest of the securitized asset in case of default. Assuming the option expense is similar to the cost of the federal government guaranteeing an FFEL loan, it would cost the institution roughly 15% of the loan's value. In this example, the cost would be around \$7.50 (15% x \$50) to buy an option to guarantee the institution's \$50 portion of the security.<sup>291</sup> Both of these proposals would achieve the goal of creating market-based risk

---

<sup>287</sup> See 20 U.S.C. § 1078(n) (1994) (repealed 1998).

<sup>288</sup> See *id.*

<sup>289</sup> Cost Sharing Proposed Regs., *supra* note 203, at 52040 (outlining certain mitigating circumstances to adjusting the cost of risk-sharing).

<sup>290</sup> 15 U.S.C. § 1078o-11 (2012).

<sup>291</sup> Assuming the average student graduates with \$20,000 in debt, an institution could pay roughly \$150 per student to cover the cost of buying an option on 5% of the debt. Five percent of \$20,000 is \$1000 (the risk retention required) and 15% of \$1000 is \$150 per graduated student (the cost of option based on federal subsidy estimates).



indicators for institutions. This risk exposure would help reduce any losses from securitization and also provide a valuable quality of education indicator to students, regulators, and accreditors.

## 2. Securitization Structures: Institutional Origination through Perkins Loans & Pooling of Federal Assets with Cost Sharing Provisions

There are two potential securitization structures for student loans, both of which offer different incentives and complexities. First, the Department could switch all of its student loan funding to Perkins Loans, which are directly originated by the institutions. The Department has recently sought to revitalize this program by making it a mandatory credit program.<sup>292</sup> Because the institutions originate the loans, they already would bear the risk of repayment. This also would provide a method to create a pilot program without overhauling most financial aid programs. To provide liquidity, the Department could purchase the loans through a program similar to ECASLA but pass any losses from securitization back to the institutions. It would then pool similar loans—either by school, major, or accreditation, as discussed below—and sell them on the private market. Any losses on the public sale would be shared with the schools.<sup>293</sup> The federal government could partially subsidize the loans by guaranteeing the loans at some minimum level.<sup>294</sup>

Second, the Department can pool its directly owned loans for securitization and require institutions to bear some or all of the risk

---

<sup>292</sup> *Fiscal Year 2013 Budget Request: Student Financial Assistance*, DEP'T OF EDUC. P-41 (2012), <http://www2.ed.gov/about/overview/budget/budget13/justifications/p-sfa.pdf>.

<sup>293</sup> For example, suppose an institution issues a \$100 loan at 5% interest to a student. If the institution chooses, it can sell the loan to the government at par value for \$100. The government would pool this loan with nine other loans of the same value and sell all ten loans together as a security on the public market for a base price of \$1000 (10 x \$100). After a competitive bidding process, the security sells for \$990 resulting in a loss of \$10. The security yields 5.1% (\$990 value / \$50 expected annual yield) to reflect the higher risk. The \$10 loss would be distributed back to the institutions that originated the ten loans at a cost of \$1 per loan.

<sup>294</sup> In the example above, the government could write through regulation that it would cover the cost of losses on security sales to a lower level. For example, a new “par” level could be \$990—with the government capping its loss at \$10—and the institution would be liable for any sale price below that new par level.

from securitization. This could be implemented by requiring institutions to agree to this cost sharing provision as a requirement for access to Title IV funds.<sup>295</sup> In this structure, the government would pass the losses from securitization back to institutions. Using the example of the \$1000 security comprised of 10 loans, if the security was sold for \$990, then there would be a loss to the government of \$10.<sup>296</sup> That loss would be distributed back to each loan proportionally; in this example, that would translate to a cost of \$1 per loan. Requiring academic institutions to compensate the federal government for losses could be enforced through the already-existing Program Participation Agreement required for each institution.<sup>297</sup>

### 3. Pooling Options for Securitization

In order to properly align incentives to academic institutions, the securitized loans need to be pooled in such a way as to provide clear quality education indicators. If the Department pooled all the loans together, there would be no way to distinguish quality programs and academic institutions from poor ones. In order to create quality indicators, the Department could pool loans by academic institution, programmatic accreditation, or institutional accreditation.

Pooling loans by institutions would be the most effective means of providing indicators through risk-based prices. This would be similar to bond prices for university debt, and it would provide very clear indicators for educational quality. Some universities, however, will not graduate enough students per year to form a marketable security. For example, the small liberal arts school of Centre College in Danville, Kentucky, graduates roughly 350 students per year, and each graduate has a total of roughly \$22,000 in student loan debt.<sup>298</sup> This would yield around \$7.7 million in assets to securitize annually, which is much too small to be marketable to investors. While this method is ideal for creating quality education indicators, securitization under this method would be impracticable.

---

<sup>295</sup> See Higher Education Amendments of 1992, Pub. L. No. 102-325, § 411(a), 106 Stat. 448, 510 (codified as amended at 20 U.S.C. 1071(c)).

<sup>296</sup> For the sake of simplicity, I am not calculating the net present value of the future cash flows but it would be included in the calculation.

<sup>297</sup> 34 C.F.R. § 668.14 (2012) (requirements for Program Participation Agreement).

<sup>298</sup> See *Common Data Set*, CENTRE COLLEGE, <http://web.centre.edu/ir/general.htm> (last visited Apr. 4, 2012).

Pooling loans by programmatic accreditation would isolate the riskiness and quality of each academic program. This form of securitization would encourage each academic program to change its policies to achieve better loan repayment outcomes. The problem with this approach, which is similar to Simkovic's risk-based pricing,<sup>299</sup> is that it would unfairly penalize academic programs that do not traditionally have high employment or salary rates—regardless of quality. This type of risk segregation is likely to be too precise. For example, medical school programs approved through the American Medical Association would lead to higher priced securities because there is less risk. Likewise, teaching programs accredited by the National Council for Accreditation of Teacher Education would yield lower prices because the average salary would be less and because employment rates are lower. This would limit an institution's ability to reform its programs so it would choose to either cut or expand programs based on perceived risk of particular professions and not based on the quality of the institution's programs.

Pooling loans through institutional accreditation would provide the largest group of loans for securitization and also would force institutional reforms through accreditors. There are two types of institutional accreditation, national and regional accreditation.<sup>300</sup> National accreditors mainly accredit career and vocational institutions or religiously-focused institutions, while regional accreditors accredit the more traditional universities.<sup>301</sup> The federal government may have difficulty securitizing an accretor such as the Transnational Association of Christian Colleges and Schools because it is comprised of only 55 schools with a combined enrollment of 17,000 students.<sup>302</sup> However, most national and regional accreditors would be large enough to form sustainable pools of loans for securitization.

To securitize by institutional accreditation, the Department would combine all loans from institutions from the same institutional accretor and sell them on the open market as a security. Any loss would be distributed back to institutions in proportion to the student loan debt that institution contributed to the security. This would encourage institutions to forum shop for accreditation from accreditors

---

<sup>299</sup> See Simkovic, *supra* note 1, at 530.

<sup>300</sup> See *Higher Education Accreditation*, *supra* note 18.

<sup>301</sup> *Id.*

<sup>302</sup> *Id.*

that are perceived as less risky. For example, the University of Chicago may be less inclined to be accredited by The Higher Learning Commission who also accredits online universities such as the University of Phoenix.<sup>303</sup> This would provide indirect incentives to accreditors to improve their standards to achieve better repayment outcomes for accredited institutions. A clear example of policy reform would be accreditors requiring academic institutions to provide academic counseling and career services to reduce the risk of bad repayment outcomes.

All of these models could utilize credit tranches to make the loans more marketable to risk-adverse investors. As part of this risk retention policy, the Department could require the academic institutions to own the riskiest tranches of the security. This would allow institutions to bear the burden of reforming its policies and programs to reduce its own costs. It also would make the securitized loans more viable investments.

Considering the history of student loans, it would be prudent to start this process through a pilot or demonstration program. This could mirror the implementation of the Direct Loan Program in 1992, which eventually became the exclusive federal student loan program in 2010. The Department could use securitization as a method to gain liquidity with the Direct Loan Program while also testing the viability of market-based risk pricing mechanisms on a small scale. If successful, the Department would have estimates of how much cost to pass onto institutions for broader programs of securitization.

Another incentive structure for institutions to participate in the pilot program would be for the Department to provide a conduit for institutions to sell institution-owned Perkins Loans similar to the ECASLA program. Institutions would be able to sell the Perkins Loans to the Department on the condition that the institutions agree to share some or all of the losses incurred through securitization of the loans. Again, this would allow the Department to test the viability of selling securitized loans on the private market on a small scale while also determining the appropriate method of risk-sharing with institutions. More interdisciplinary research is needed to test the viability of these securitization concepts and potential pilot programs. The proposals here are meant to encourage additional research to determine the best

---

<sup>303</sup> *Directory of HLC Accredited Institutions*, THE HIGHER LEARNING COMMISSION – NORTH CENTRAL ASSOCIATION, <http://www.ncahlc.org/Directory-of-HLC-Institutions.html> (last visited May 20, 2013).

approach to reduce government risk and provide quality education indicators.

## VI. CONCLUSION

Federal financial aid is currently at risk of faltering because of unrecognized accounting risks in the budget and balance sheet. This inevitably will lead to some accounting reform, either through FCRA reform or through agency changes in repayment and discount rate estimates. History has shown that student loan reform primarily occurs because of favorable treatment in the federal budget and balance sheet, not because of bad student outcomes.<sup>304</sup> Given this assumption, the Department has an opportunity to introduce some form of loan securitization to reduce risk exposure, capitalize loan assets to reduce the budget costs, and introduce a new quality of education indicator to postsecondary education by using market-based risk.

The recent Student Loan Certainty Act has laid the foundation for the federal government to use market-based pricing with student loans to reduce federal budget and balance sheet risks. The legislation also demonstrates Congressional support for policies with short-term upfront costs in exchange for long-term risk reduction to the federal government. Academic institutions are the parties most capable of bearing the market-risk from student loan repayment rates because students have asymmetrical information and the federal government cannot regulate the quality of education. Furthermore, academic institutions and accrediting agencies are best able to respond effectively to securitization incentives through academic advising, choice of programs, and curriculum. While not a panacea, securitization provides a policy mechanism to reform our current student loan programs and create a new quality education indicator.

---

<sup>304</sup> See *supra* Part II.